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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1986

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 23, 1986

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1986

WEDNESDAY, JULY 23, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Riegle, Sarbanes, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning's hearing comes at a time when there is more than the normal level of uncertainty about the economy and about monetary policy itself.

While yesterday's announcement by the Commerce Department on real growth this year shows that the economic expansion that began in 1982 is continuing, the rapid growth in the M1 monetary aggregate that began late in 1984 has yet to produce the acceleration in real growth that many analysts have been predicting.

Similarly, the decline in the value of the dollar on foreign exchange markets since early last year has yet to produce the improvement in the U.S trade and current accounts that analysts have been predicting.

The decline in the price of oil since late last year has yet to produce the benefits for the economy in terms of real increases in spending that have been forecast.

Declines in interest rates have not provided the hoped for stimulus in real economic growth.

The rate of growth in the M1 monetary aggregate has become suspect as an indicator of the relative tightness or looseness of monetary policy.

Questions have been raised as to whether declines in nominal interest rates have masked increases in real rates arising from even faster declines in inflationary expectations.

Commodity prices, interest rates, and the foreign exchange value of the dollar have been suggested more and more often as the focus of monetary policy, either in place of or in addition to targeted increases in the monetary aggregates.

Unprecedented declines in velocity have raised questions as to whether our current method for calculating velocity—which uses nominal GNP as a proxy for spending in the economy—might not be out of date.

I have long believed that uncertainty is not healthy for an economy, primarily because it impedes planning. That is why I have continued to support quicker release of the minutes of the Federal Open Market Committee [FOMC] meetings.

Our task today, as I see it, is to try to reduce some of the unusual level of uncertainty surrounding the course of the economy and of monetary policy.

While serious problems remain in agriculture, energy, and certain other sectors of our economy, we must also remember that we do have an economy that is in the midst of one of the longest economic expansions in the postwar period. That economy is continuing to produce jobs at record rates.

We have made significant progress toward wringing inflation out of the economy. Interest rates have been reduced markedly.

As is evidenced by Mexico's new accord with the IMF, progress is being made on the problem of the heavily indebted LDC's. The dollar's value on the foreign exchange markets has come down to more realistic levels that will help to correct our trade and current account imbalances. Finally, we have a new agreement among the G–7 nations to work together to resolve our common economic problems.

Fortunately, as we work to reduce uncertainty and to resolve our remaining problems, we at least seem to have a firm economic foundation on which to stand.

Mr. Chairman, we look forward to your testimony this morning on these matters, but before we turn to you I'd like to turn to my colleagues to see if they have any remarks they wish to make.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you very much, Mr. Chairman.

Mr. Chairman, I'm delighted to see the Chairman of the Federal Reserve Board before us this morning. I think that in the many years I've been in the Congress I can't remember a time when the economic situation was so puzzling. It's always puzzling, but it seems to me that it's a lot more puzzling now than it's ever been, for many reasons.

I would just like to spend a minute dwelling on one subject that I think tends to be forgotten. It is a rare day—in fact, I would say it's a cold day in July in Washington when Members of the Congress ever criticize the Federal Reserve Board for pursuing too expansionary a monetary policy. That just doesn't happen. The reverse is almost always true, for obvious political reasons. We always like to see low interest rates and we always figure that if they'll just loosen up on the money supply, interest rates will go down. That habit is a hard one to die, but I think it's about time it did die, in spite of the fact that we are now in a situation where we have a slowed economy.

Memories are notoriously short in the political arena. Many of us have conveniently forgotten the double digit inflation in the late 1970's and early 1980's that almost wrecked our economy. Today we hear more politicians calling for a growth-oriented monetary policy reminiscent of the Keynesian liberals of the 1960's.

On the other hand, there are still many reasons for concluding that there will be a resurgence of inflation in the next several years. First, we have had the biggest peacetime budget deficits in the history of this or any country year after year after year for 5 consecutive years—a highly inflationary policy on the basis of all historical experience and on the basis of any kind of reasoning.

Second, we've had the extremely explosive growth in the money supply in 1985 which will take 1 or 2 years to reflect itself in prices. And I might say, apropos of that, Mr. Chairman, that your original statement and report indicated that M1 will be given less attention than the other monetary aggregates. Indeed, some observers have concluded that the Fed has decided to virtually ignore M1 as a relevant monetary target.

For example, in the first week of July, M1 increased by a whopping $7.4 billion or more than 1 percent. That would produce an annual growth rate of over 50 percent if continued.

I might also point out that we have had a sharp decline in the value of the dollar which will raise the cost of imports and ultimately domestic goods. Finally we have the one-time bonanza realized from the sharp drop in oil prices and that's bound to be reversed.

For these and other reasons, I have real doubts that we have inflation permanently under control.

Finally, Mr. Chairman, I am concerned about the fact that if we do suffer further stagnation, a growth recession, or an actual recession, it's very, very hard to know what policies we can pursue under present circumstances. Do we deepen the deficit? I presume we do. $200 billion isn't enough; we go to $300 billion, maybe $400 billion. We've deepened deficits in the past when we've moved into recession. Do we have an even faster growth of the money supply? As I pointed out, last week broke all records and the last year has broken all records for M1; M2, and M3, while they're within their targets, the targets are far too generous in view of the level of inflation and nominal GNP growth.

At any rate, Mr. Chairman, I think that we are now in an extraordinarily difficult challenging time and it's going to be interesting to hear perhaps the wisest person who's presided over the Federal Reserve in the 30 years I've been here and that takes in a lot of very, very able Chairmen.

The **Chairman**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

I'm going to ask that my statement be placed in the record as if read in its entirety.

The **Chairman**. Without objection.

OPENING STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. For several years we have watched and discussed with Chairman Volcker the expansion and contraction of M1 and the effects of this expansion or contraction upon the economy. From the testimony this morning, it appears that Chairman Volcker is admitting that during the last 2 or 3 years the Fed has been paying too much attention and placing too much emphasis on the effects of M1 on the economy. Now Chairman Volcker suggests that we discount the impact of M1.

I can't help but say that I think we've been too tightfisted. The discount rate should have been cut sooner. I said it last time you appeared. We play this game as if the Federal Reserve and the Chairman is the only person who really can speak with any authority as to what the needs of the economy are. I disagree with that. I'm not going to go back to the late 1970's when we saw the same Chairman loosen up the money supply and drop the rates that resulted in spiraling inflation.

I do not advocate the loosening of the money supply to ignite inflation. Rather, I am concerned that the Fed move too far in the opposite direction and by doing so unnecessarily impede economic growth. The inflation fears that I've heard expressed time and time again have not come to pass. The last discount that we had was too little and too late.

I'm sorry to see that some of my colleagues might say that privately but when we come publicly in front of the Chairman, his great reputation and experience, et cetera, is such that they are reluctant to encourage you to lower the discount rate even further. But I'm saying it. I said it last time, Mr. Chairman. I thought that we should have had the cut earlier and I think that the cuts that you finally made after a great deal of rancor behind the scenes should have taken place much earlier. While we should be ever mindful of the perils of inflation, we should also make every attempt to avoid the problems attendant to a recession.

I am not suggesting to you for one moment that the slowdown in the economy is simply as a result of the failure to increase the money supply and drop the discount rate, but certainly these are contributing factors.

Further, many of the Nation's ills in the manufacturing sectors of our economy have resulted from a lack of a trade policy. I think this Nation has no trade policy and it's led to a lot of the job dislocation.

Having said that, I will ask that my remarks be entered into the record again as if read in their entirety, Mr. Chairman.

The **CHAIRMAN**. Without objection.

[The complete prepared statement follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

I appreciate the time and efforts of Chairman Volcker who appears before the committee once again to report on the conduct of monetary policy.

While I don't want to be an alarmist, I feel that we cannot overlook the depressed conditions of the agricultural and energy sectors of our economy. The current drought in the Midwest, Southeast, and Southwest and the continued depressed prices of crude oil will only exacerbate the problems confronting farming communities and those communities depending upon oil production. Further, heavy industry in this country remains in the midst of a prolonged slump. The financial difficulties confronting primary industries such as steel have been most recently exemplified by the bankruptcy of LTV Corp. last week and the recent closing of General Electric's gas turbine plant in Schenectady, NY. Clearly, the concerted effort to drive down the value of the dollar has not assisted these industries by encouraging the growth of U.S. exports as anticipated. Therefore, more dramatic actions must be taken.

Although Chairman Volcker cites the creation of more jobs in the last year, I wonder how many of these new jobs are in the relatively low wage fast food or computer programming sectors while the jobs lost to foreign competition or due to economic downturns in rural America or the oil patch are relatively high paying jobs. Could it be that although the number of Americans working has increased, the quality of living for many Americans has actually fallen?

In citing these examples, I don't mean to lay all of the country's economic woes at Chairman Volcker's feet. However, on a day to day basis, the decisions of Chairman Volcker and his colleagues on the Federal Reserve Board have a dramatic and immediate impact on the health of the American economy and the economic welfare of millions of Americans. Let's face it Chairman Volcker, you are a very important man in determining the rate of this Nation's economic growth and well-being. Behind the facts and figures you cite are individual Americans experiencing economic hardship. I think that a little dose of economic expansion is in order. The GNP grew at the paltry rate of only 1.1 percent in the second quarter of 1986. If a fundamental economic adjustment need be made in the near term, I would suggest lowering the discount rate even further. I know the rate was recently cut, but was it cut enough?

In your recent appearances before this committee, some of my colleagues and I have consistently urged you to lower the discount rate and increase the money supply to stimulate expansion. Each time we address these issues, you always respond by articulating your concerns with rekindling runaway inflation. Well let's look at the facts. On March 7, 1986, the discount rate was reduced from 7½ to 7 percent, on April 18, 1986, it was cut again to 6½ percent and on July 11, 1986 to 6 percent. Is there any evidence that these cuts have resulted in higher than anticipated inflation increases? Despite the many charts and graphs in the Board's monetary policy report, there are none that demonstrate a rise in the inflation rate that corresponds to a lowering of the discount rate over the last 12-month period. Therefore, the answer to my question is: "No—inflation has not been rekindled." More importantly, economic expansion in 1986 has not been rekindled either. I agree that rates should not be artificially reduced, however, I have yet to comprehend how you determined what constitutes a real versus an artificial reduction. Would anything more than a one-half percentage point drop be artificial? Is there any real reason why the rate wasn't recently lowered to 5½ percent?

Perhaps concerns about inflation should not be your paramount concern and the growth of the economy through the increased availability of credit and the growth of the money supply should become the Board's major preoccupation. Monetary policy can and must be designed to sustain the economic expansion that has continued longer than most. To achieve this goal, I think you should be serious about being, as you said in your monetary policy report for last year, "Generally accommodative to emerging demands for money." To this end, you should be serious about lowering the discount rate and increasing the money supply. Recent experience has demonstrated that functional decreases in the discount rate and increases in the money supply have not resulted in a significant amount of inflation, let alone skyrocketing inflation. Therefore, logic dictates that the rate should drop further and the money supply should be increased.

I look forward to your testimony and your responses to the issues raised by my statement.

The **CHAIRMAN**. Senator Riegle.

Senator **RIEGLE**. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR RIEGLE

To follow on a little bit here—and I'll make these remarks brief—in today's Wall Street Journal, Al Wosenhower, the chief economist of First Boston, is quoted as saying, that in times such as we have at the moment, "Monetary policy is like an aspirin. It helps, but it cannot play a fundamental saving role."

It seems to me that that is quite accurate. Monetary policy is a very important component of overall economic strategy, but it is not in any respect a cure-all. I think that it is quite limited at particular times what monetary policy can do to drive the economy or fix other problems.

We might wish that it were otherwise, but that's a fact, and it is not to diminish the importance of monetary policy. It is extremely important, but I think there are a lot of other factors in the policy mix here.

I want to say to you, Chairman Volcker, that I appreciate very much the job that you have done over a long period of time. I think whether people agree or disagree with different policy calls at different times along the way, your leadership has been critical during this period of time and may be even more so in the period ahead.

As I look at the economy, I see enormous difficulties out there. I think if we take the right steps we can deal with them, but that's by no means automatic. We see weak growth here and around the world. We see the enormous trade deficits. We see the huge budget deficits. We're going to probably exceed $220 billion this year and there is a slippage on the revenue side which is beginning to widen out those deficits. We've got the oil problems, and the banking problems which I will be discussing with you a little later. There are foreign debt problems, and the agricultural problems particularly here in the United States. It seems increasingly difficult to achieve international coordination of our economic policies and you stress that in your statement today—the importance of that kind of coordination, especially among the major Western nations.

I gather, not happily, the last discount rate you took without that coordination, you and the Board as a whole must have felt enough of a sense of urgency to cut the discount rate by doing it without being able to get a simultaneous response from the Japanese and the Germans particularly.

I am concerned about that and I hope that you will shed some light on it later.

All of this is by way of getting to the point that I really want to make here and that is, none of us know what's ahead. In 1983 you said before this committee, that when you were confirmed you were not going to commit yourself to necessarily serve out a full term. You went on to elaborate under questioning that you thought a President, after being elected, ought to have, perhaps after a year or so, an opportunity to appoint a Fed Chairman of his own choice. We're approaching that 1-year period. Your term, if you stay the full term, ends at the end of 1987 or late in 1987, and I hope you'll stay. I don't know what your plans are, but my great concern right now is one of maintaining public confidence in this country. I think the role that you have played, and I think can continue to play, is a very important part of maintaining that public confidence through a very turbulent and difficult period.

I don't know if you can enlighten us in that respect today, but as one member of this committee, I hope that you will fill out the full term. I think it's very important, particularly at this time.

The **Chairman**. Senator Mattingly.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator **Mattingly**. Thank you, Mr. Chairman.

I'd just like to welcome Chairman Paul Volcker again to a full hearing room, a standing-room-only crowd. I guess maybe we ought to start moving to bigger quarters. Obviously, you draw a bigger crowd than anybody else that comes before our committee here.

I would like to say one thing in reference to the remarks being made and of course in the paper in reference to the GNP at 1.1-percent growth. At least it's growth. At least it's heading in the right direction.

I would like to also try to comment in reference to the Senator from Michigan, my good friend Senator Riegle, when he referred to the deficit that we have. I would like to say on the positive side that what we see Congress doing in reference to the 1987 budget is making certain that we keep the constraints on the deficit to $144 billion, and so far so good on that. We seem to be winning that battle, and hopefully by the time we go into October 1, that we'll have a budget deficit that has dropped tremendously and dramatically, and that's been brought on by a new process that even though some of the Congress are a little skittish of, I'm glad they're skittish of it because obviously it's working.

I'd just like to reinforce what Senator D'Amato said, I'm glad to see you here today and I hope that you make an announcement today of how far the discount rate will drop. Because I don't know what you have in your speech, I'm waiting to hear it. But, if it's down there somewhere toward the end, if you would give that first it would be better.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

I, too, want to welcome Chairman Volcker this morning before the committee. I sometimes think when we're discussing this great engine that we call the American economy we're very much like the fable of the five blind men who examined an elephant and one felt the elephant's leg and thought it was like a large tree. Another felt his trunk and felt it was like a slithering serpent. All of us look at the economy and come back with a different diagnosis for the problem.

Some of my colleagues have their own diagnoses and I'm sure the Chairman does also, but one that occurs to me and keeps recurring is that we're paying the price in this economy for the most unorthodox fiscal policy that we have pursued in this Government, probably the most unorthodox in this century. We're going from one planned structural deficit after another, year after year after year, and neither this administration, which in my judgment should furnish the leadership for dealing with the deficit, nor the Congress has been able to face up to this very, very serious problem.

Now I have been critical of the Federal Reserve Board and this Chairman in times past for not lowering the discount rate enough and in what I thought was a timely fashion. But let's face it, the Fed and this Chairman are in a very precarious position. We are borrowing at the present time about $100 billion in foreign funds to finance an enormous Federal deficit. We are attracting these funds with relatively high interest rates. If we get into the posture of lowering this discount rate too rapidly, too precipitously, then we could very easily and quickly see an exodus of foreign capital from this country which I think could be a fiscal disaster and could also be a disaster for what I perceive to be a relatively shakey financial structure in this country.

The administration's growth estimates have been off the mark, as they have been characteristically now for almost 6 years, and I hope this morning that the Chairman can apply a little reality to these growth estimates and numbers that we've been hearing.

So I welcome you, Mr. Chairman, and look forward to hearing your statement this morning.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Chairman Volcker, we welcome you back to this committee. You're no stranger to this committee. What I suppose many of us are really asking you—and we hope you do have a chance to testify some time this morning—is why, with economic conditions as they are, with the economy certainly at best soft, with retail sales flat, with oil, gas, and the farm economy deeply troubled, with basic industry very sick, the LTV bankruptcy of last week reminding us of that, with auto sales from time to time going soft, with the consumer price index for the first half of this year having grown at a negative rate of zero or below, with the wholesale price index having been minus 12.4 percent in the first quarter, minus 0.1 percent in the second quarter, why, in view of the deflationary trends in this economy, should the discount rate or interest rates be at 6 percent in the case of the Fed, 8.5 percent in the case of the prime rate, especially since there seems to be little or no demand for capital?

When I say there's little or no demand for capital, what I'm referring to is the indication that weekly loan and paper demand is flattening out; business credit actually seems to be dropping; personal loans at banks have tapered off. About the only thing that keeps going strongly, according to the statistics I have, are real estate loans at banks. Scarcely a tremendous amount of demand.

It seems to me that those people—I number myself among them—who call for a further drop in the discount rate are on solid ground in indicating that there's certainly no reason to believe this is going to bring about a wave of inflationary stimulation.

World oil production is at a high since 1981 or 1982—remarkable—and the price is expected to stay quite soft. Our trade deficit, of course, remains at a record. By the way, it's interesting to me that it remains at or above record rates in spite of the fact that our biggest import, oil, is selling at the lowest price that most of us can remember.

You have indicated in your statement that you feel that a lot of the problem is America's trading partners, particularly I assume you're referring to the Germans and the Japanese who have refused to stimulate their economy, restimulate their economy, and that that is a depressant on the world economy of which we're a part. I don't quarrel with that. I think they should do a better job of managing their economy.

Yet it doesn't answer the question of why there should be relative to inflation such high returns to capital when the wholesale price index is going down, when the consumer price index is going down or is for all intents and purposes flat, and when there is no substantial demand. Demand seems to be falling relative to previous growth of demand for capital, for loans, for credit. It's significant to me that per capita income—not family income but per capita income—has been almost flat since 1968. One way of putting that is that the returns to capital have never been better; the returns to labor are not very good and at the present time seem to be falling.

Something seems to be wrong and beyond just blaming our trading partners for it—and I think they do deserve some of the blame—I hope you will address that issue.

The CHAIRMAN. Senator Hecht.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you, Mr. Chairman.

Nice to welcome you, Chairman Volcker. I didn't get to this august body until 1982 and as a businessman in the late 1970's I struggled under 20 percent plus prime rate, 12 percent inflation, so I say to you that you have made remarkable progress. We have much work to do. I'm anxious to hear from you and I think we should work together because certainly Congress shares a large amount of responsibility for this huge deficit. Thank you.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, we are here to consider the semiannual monetary policy report of the Federal Reserve Board. This hearing comes at a time of great uncertainty in the economy.

Federal deficits for this year will likely be significantly greater than last year's record level. Economic growth, however, is likely to be lower than had been expected when the budget resolution for this year was put together. While the money supply has increased fairly rapidly in recent months, inflation is low, and interest rates are down. Yet cheaper loans and low inflation have not resulted in higher levels of production; the percentage of factory capacity in use is falling.

The international scene is equally unsettling. The dollar has fallen significantly over the past year, but the trade deficit does not seem to be falling at all. The International Monetary Fund has been able to put together a loan package for Mexico that is getting generally favorable reviews, and which should avert a default in that country, but today's papers indicate we could have an unprecedented default in Peru by August 15.

What is most disturbing is that neither the behavior of our domestic economy nor the world economy seems to be adequately explainable under the old rules. Conventional wisdom would suggest that low inflation, a falling dollar, falling U.S. interest rates, a very expansive fiscal policy as measured by the deficit, and a rapidly growing money supply should produce higher rates of economic growth. But economic growth is falling. Our economy is becoming more and more sluggish.

I look forward to hearing from the distinguished Chairman of the Federal Reserve, therefore, and to receiving the benefit of his analysis and recommendations on how best to come to grips with this uncertain economic situation. Thank you.

The CHAIRMAN. Mr. Chairman, now that you have had the opportunity to hear all of our nonsolutions to the economy, I would also advise you that you have other parliamentarians to listen to you today. We have 11 committee chairmen from the Canadian House of Commons visiting the committee this morning, so you have a wide audience of politicians for your views. The Canadian Government is also listening this morning.

So we would be happy to hear from you at this time.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman, and I think you all have emphasized one way or another the difficult and challenging times in which we live and I agree that they are. I appreciate the opportunity to report once again in this context on the conduct of monetary policy. I would first like to place that matter in the larger context of the performance of the United States and the world economy.

MIXED PERFORMANCE

As you know, there have been marked contrasts in the economic performance of different sectors and regions of this country. Consumption has been strongly maintained, and there have been large increases in employment in the broad service sector. Housing is being built at a high rate. But industrial activity and business investment, which had leveled off last year, have declined over the last 6 months, and the agricultural and energy industries are under strong pressure. As a consequence, activity in some areas of the country has advanced rather strongly, while severe adjustments are taking place in the energy and agricultural belts.

The net result is that the overall economic growth rate in the United States moderated to about 3 percent through 1985 and early 1986, and apparently slackened further in the second quarter of this year. Moreover, growth in other major industrialized countries remained slower than in the United States during 1985 and the early part of this year.

Throughout this period, sizable increases in employment have continued in this country; the unemployment rate has remained generally at a little over 7 percent and, relative to the size of the working age population, more people are employed than ever before recorded. In Europe, unemployment has also remained relatively steady, but at much higher levels.

After more than 3 years of economic expansion, the process of disinflation has continued, reinforced for the time being by sharply lower prices of oil, by far the most important commodity. With industrial prices steady, the average level of wholesale prices has been declining here, and even faster in key countries abroad whose currencies have been sharply appreciating relative to the dollar. Interest rates here and abroad have also declined appreciably, reflecting both the sense of progress against inflation and the fact that growth has been proceeding well within capacity restraints.

The large decline in U.S. interest rates and the sharply higher stock market over the past year suggest the cost of capital has declined. The fall in oil prices has helped bolster the real income of consumers. Meanwhile, the substantial depreciation of the dollar has placed our industry in a decidedly better competitive position vis-a-vis other industrial countries. As many have suggested, these underlying forces should help sustain an economic expansion that has already lasted longer than most.

FUNDAMENTAL ADJUSTMENTS MUST BE MADE

But I would be remiss in failing to emphasize much less satisfactory aspects of the United States and world economic situation. There can be no evading the fact that some fundamental economic adjustments must be made within our economy in the months and years ahead.

The clear challenge is to find the ways and means to work through those adjustments in a context of sustained growth while also consolidating and retaining the progress toward price stability. The conduct of U.S. monetary policy is obviously relevant to that process. But that single policy instrument cannot itself provide the answer. Complementary approaches in the fiscal, trade and other policies of this country, and in the approaches of other countries, will be required as well. The hard fact is that, while the need for complementary actions to achieve the necessary adjustments in the United States and world economy seems to be more widely recognized, progress in coordinating action toward those aims has been limited.

Some obvious imbalances have developed in the economies of the industrialized world. That is evident most of all in the enormous deficit in our external trade and current accounts, and in the counterpart surpluses of a few other countries. Unless dealt with effectively and constructively, growing market and political pressures will, sooner or later, inevitably have much more disturbing consequences.

The problem clearly emerged some time ago. The powerful thrust of the strong U.S. economic expansion in 1983 and 1984 had spilled out abroad in the form of sharply rising imports, aided and abetted by the exceptional strength of the dollar internationally. There were, for a while, benefits on all sides. At a time of slack demand at home, exports to us helped Europe and Japan to restore and maintain their growth. The United States also absorbed a disproportionate share of the necessary external adjustment efforts by the heavily indebted countries of Latin America. Those countries have sharply curtailed their imports since 1982, and they have become more competitive in markets for manufactured goods.

At the same time, the United States began to be the recipient of a growing flow of capital from abroad. That inflow, which pushed the dollar so high in the exchange markets until early 1985, had the practical effect of relieving potential pressures on our internal financial markets even in the face of the massive and growing Federal deficit. Consequently, private investment and construction could expand. At the same time, the competitive pressure from imports encouraged strong cost-cutting and productivity efforts in the industrial sector. That has been one powerful factor accounting for the near stability of prices of manufactured goods over the past year or more.

We cannot, however, build a lasting foundation for sustained growth and stability on massive international disequilibrium—huge and rising trade deficits in the United States and counterpart surpluses abroad. Nor can we count on satisfying indefinitely so much of our own needs for capital by drawing so heavily on the savings generated elsewhere in the world—savings that have been so freely available in part only because internal growth in Europe and Japan has been relatively slow.

STRAINS FROM IMBALANCED ECONOMY

Today the imbalances and strains are clearly showing. The forward momentum of our economy has been sustained almost entirely by consumer spending and housing construction, both of which have been accompanied by unsustainably heavy borrowing. Savings meanwhile have remained at a relatively low level, even by past U.S. standards. For more than 1 year, industrial production in the United States has not grown appreciably, and there has been some decline in 1986. The pace of business investment has slackened.

Some of the relative weakness in industrial output and investment over the past 6 months can be attributed to temporary factors and to developments peculiar to the United States. For instance, some investment orders were speeded up late last year in anticipation of tax reform, and the debate on the nature of that reform has apparently led to some deferral of ordering this year. The boom in spending for computers has subsided and commercial construction, in response to large and growing vacancies of office space, is predictably declining. Probably much more important in recent months have been very sharp cutbacks in domestic oil exploration and investment, driving energy producing States into recession-like conditions and affecting production of steel and equipment elsewhere as well.

But a large part of the difficulty stems from the continuing imbalances in the world economy. On the average, growth rates in major European economies and Japan were about three-fourths percent less than the reduced growth path of the United States during 1985 and the first quarter of 1986. However, the more disturbing contrast lies in the source of that growth.

In the United States, the rate of growth in domestic demand, while slowing in the third year of expansion, continued to average about 3¾ percent through that period. Domestic demand growth in the industrialized countries of Europe and Japan was significantly less—about 2½ percent. In the early part of this year, when their exports slackened, those countries grew not at all.

The plain implication is that our overall GNP growth rate was reduced by continuing deterioration in our trade and current account balances. With our current account deficit reaching a record $135 billion annual rate in the first quarter of this year, industrial production and investment were restrained. Meanwhile, foreign surpluses continued to build through much of the period, and as their exports have slowed, internal demand has not yet, in most of those countries, picked up the slack.

Prospects for investment and for manufacturing activity in the United States are heavily dependent on an improved trade outlook. The sharp decline in the dollar since its peak in early 1985 should help set the stage for such an improvement. There is evidence that U.S. producers find themselves in a stronger competitive position. However, the deterioration in actual trade in manufactured goods has slowed little.

The decline in the dollar is both relatively recent and from a very high level so the absence of a stronger response in trade so far is not entirely surprising. What is of concern is that the domestic markets of our major industrial competitors have remained so sluggish, raising a question as to the buoyancy of the markets for our exports and of their own growth prospects.

PROTECTIONIST PRESSURES ARE NOT THE ANSWER

You are well aware that the present imbalance among industrial countries is reflected in strong protectionist pressures in the United States. Yet, as the President has so strongly emphasized, to abandon our tradition of relatively open markets would surely be to invite an unravelling of the international trading order. We would then have less trade and more inflation. With that, prospects for sustained growth both here and abroad would clearly be placed in jeopardy.

I know of the complaints about unfair trading practices of other countries. We need to deal with them energetically. But I also know the clear lesson of experience is that a protectionist retreat by the United States, the world's leading economic power, would invite recrimination and escalation. Certainly, the most effective and promising avenue for dealing with the trade complaints on all sides will be in the planned round of multilateral trade negotiations rather than in a tit-for-tat process of mutual retaliation.

Moreover, I believe it is demonstrable that, as a matter of relative importance, much more fundamental imbalances in the world economy than unfair trading practices are responsible for the present pattern of trade deficits and surpluses. Those underlying imbalances can only be dealt with by complementary economic policies, not protectionism.

Quite clearly it is in no one's interest—not the United States or other countries—that we seek better balance in our external accounts by deliberately restraining further our own growth rate. But it is also true that as things now stand, stronger domestically generated growth in the United States will not reduce the international imbalances. Taken alone, it would aggravate our trade deficit further, posing an even more difficult adjustment problem later.

As I suggested, the recent exchange rate changes can help us to escape that dilemma—they should work to improve our trade position and reduce the surpluses of others. In fact, faced with a combination of appreciating currencies and slower growth in overseas markets, exporters in both Japan and some European countries are experiencing reduced profits and more sluggish orders from abroad.

However, in the absence of offsetting internal sources of expansion, those same pressures could dampen their own prospects for growth.

That is one of several reasons we should not rely on exchange rate changes alone to produce the needed international adjustments in the world economy. Over a number of years, we in the United States will certainly need to shift more of our resources into exports, and into recovering domestic markets where import penetration has been so high. That, very broadly, implies relatively more growth in manufacturing; relatively less growth in services, in governmental spending, or in other sectors; and more savings and less borrowing. For some of the rest of the world, the opposite shift will need to be at work—less reliance on exports, and more on domestic sources of growth.

Much still needs to be done to ease the way for those adjustments. For one thing, we in the United States are not prepared for a really large improvement in our trade balance. Our financial markets remain dependent on the large capital inflows from abroad that are a necessary counterpart of our trade and current account deficits. Moreover, taken by itself, depreciation of our currency in an effort to redress the trade deficit poses a risk of renewed inflation.

Only as our huge Federal deficit is cut can we comfortably contemplate less borrowing abroad and provide assurance against renewed inflation. Put another way, in a growing economy, reductions in the Federal deficit will be necessary to release the real and financial resources necessary to improve our trading position in a way consistent with rising investment.

In a few foreign countries, such as Germany, some signs of stronger internal growth have appeared in recent months. But such signs are far from uniform among key countries abroad, and most projections of their growth for this year have been lowered, not raised, as exports have slowed.

With rising currencies and falling oil prices, some of those countries after years of effort have now successfully achieved virtual stability in consumer prices. Moreover, their wholesale prices have declined sharply and are appreciably lower than 1 year ago.

All of us—and certainly this central banker—can appreciate the importance of maintaining a broad framework of stability and appropriate financial disciplines to sustain that progress. What is at issue for some countries is their ability to achieve and maintain vigorous internal growth at a time of high unemployment and ample resources as external stimulus fades away, as it must if international equilibrium is to be restored. The appreciation of their currencies and the strong deflationary influences of low oil and other commodity prices would appear to offer a prime opportunity for reconciling those goals of domestic growth and stability.

PROGRESS IN COUNTRIES SOUTH OF OUR BORDER

Four years after the international debt problem broke into our collective consciousness in 1982, when Mexico abruptly lost access to international credit markets, that threat to our mutual prosperity remains. The renewed difficulties of the oil producing countries today should not, however, obscure the progress that has been made. Collectively, the heavily indebted countries of Latin America and elsewhere have made an enormous effort to adjust their external accounts; in fact in 1984 and 1985 they were in rough current account balance, in contrast to an aggregate deficit of about $50 billion in 1982.

To be sure, that effort for a time was accompanied by sharply lower imports, recession, and lower standards of living as they brought their spending more in line with their internal resources. But it is also true that many of those countries are again growing, in some cases with vigor, as is the case with the largest single debtor, Brazil. Helped by the reduction in world interest rates, external interest burdens have been reduced appreciably in some countries relative to exports or other measures of capacity to pay. A number of Latin American countries have also made striking progress in dealing with ingrained inflation for the first time in many years, in the process gaining political support. There has been considerable, if uneven, progress toward liberalizing their economic structures in ways that should encourage more growth and productivity over time.

In the midst of this progress, the sharp decline in oil prices over the past 6 months has had an enormous adverse impact on the oil-exporting heavily indebted countries—Venezuela, Nigeria, Ecuador, and Mexico. At current oil prices, for instance, Mexico would lose about one-third of its 1985 exports, perhaps as much as 15 percent of its Government revenues, and the equivalent of some 5 percent of its GNP. Inevitably, that situation poses a new and severe challenge for Mexico—a challenge that will require strong new efforts to make the necessary economic adjustments and to improve the structure of their economy. There is no large cushion of external reserves to buffer the shock. Consequently, a large amount of financial resources will have to be marshalled from abroad to help ease the transition, to maintain continuity in debt service, and to provide a solid base for renewed growth.

That combination of adjustment, structural change, and appropriate financing is, indeed, the essence of the approach announced by the Mexican Government earlier this week. In cooperation with the IMF and the World Bank, Mexico is undertaking a wide range of efforts to deal with both its short and longer range economic problems. To my mind, their efforts, in the midst of crisis to move toward a more open, competitive economy, are particularly encouraging. They have joined GATT, import restrictions are being rationalized and liberalized, a good many state-owned enterprises are being made available for sale—or, if too inefficient, shut down—subsidies are being reduced and eliminated, and procedures for approving foreign investment eased. If carried through effectively, those measures promise to work toward fundamental improvement in the efficiency, competitiveness, and creditworthiness of the Mexican economy, thereby enhancing prospects for longer term growth.

Today, that country is in recession. But the program clearly contemplates economic recovery in 1987 and 1988. Certainly, sizable amounts of financing from abroad will be required to support that effort. About half of that can be committed by the IMF, the World Bank, and the Inter-American Development Bank. But Mexico is calling upon commercial banks, with so much already at stake, to play a large role as well.

In assessing that situation, I would note that the Mexican exposure of commercial banks appears not to have increased for some 18 months. Indeed, there has been little net new lending to Latin America as a whole over the past year.

Taking the entire period since mid-1982, the exposure of American banks to the heavily indebted countries of Latin America relative to their capital has declined appreciably. That ratio fell from about 120 percent of the capital of lending banks to less than 75 percent at the end of last year, a decline of 38 percent. No doubt, there has been a further reduction by now.

Those exposures, in relative terms, are actually considerably less than in 1977 when the data were first collected. For some time, the pace of lending has, in fact, been well below that contemplated by Secretary Baker when he set out a framework for a growth-oriented approach toward the international debt problem at the IMF meetings last autumn.

That initiative—essentially contemplating a combination of strong adjustment efforts and structural reform by the indebted countries with reasonably assured financing by international institutions and private banks—is now being tested. It is being tested in difficult circumstances not foreseen at the time—the sharp break in oil prices. But the basic community of interests among borrowers and lenders—and the world at large—in a coherent, cooperative approach is as strong as ever.

The debtor countries themselves have an enormous stake in maintaining their creditworthiness and in seeking solutions in the framework of open, competitive markets. We all have a strong interest in international financial order—all the more when there are other points of strain in the banking system. And, of course, relationships beyond the purely economic are at stake, for the United States most of all.

BENEFITS OF OIL PRICE DECLINE

The challenge is large, but with cooperation, also manageable. Indeed, the same oil price decline that has undermined the budgetary and trading position of Mexico and other large oil exporters has relieved the pressure on those importing oil. Interest rates have declined. A number of borrowing countries will require significantly less, rather than more, financing than was contemplated 1 year ago. Given the enormous progress made in adjusting external positions, most of the borrowers can look toward more balanced expansion in their imports and exports as they grow—among other things, providing renewed opportunities for American exporters.

But I must also emphasize one essential ingredient for success beyond the capacity of the indebted countries to manage. Only a stable, growing world economy, with markets open to the developing world, can provide an environment conducive to economic expansion, more normal interest rates, and orderly debt service by the borrowers. That ingredient is plainly the responsibility of the industrialized world alone. It is one of the reasons why we must collectively deal with the obvious imbalances among us.

These larger issues were the background against which the Federal Reserve has conducted monetary policy in 1986 and reviewed its objectives for growth in money and credit this year and next. The results of the review by the Federal Open Market Committee [FOMC] of target ranges for money and credit for 1986 and tentative ranges for 1987 were discussed in the Humphrey-Hawkins report published and sent to the committee at the end of last week. That report also sets out projections for real activity and prices of FOMC members and Reserve bank presidents.

As indicated in the report, the posture of monetary policy remained broadly accommodative over the past 6 months. The discount rate has been reduced in three steps this year by 1½ percent, in part responding to and in part facilitating declines in short-term interest rates of similar magnitude. Long-term interest rates also moved lower, extending the sharper drops in the second half of last year. The general structure of interest rates is now as low as at any time since 1977.

The reductions in interest rates in 1985 and 1986 have clearly helped support the more interest-sensitive sectors of the economy, reflected in part in the highest level of housing starts since the late 1970's. The declines have also helped ease the debt servicing costs of businesses, farmers, developing countries, and the U.S. Government itself.

On the other side of the ledger, as interest rates have declined, the rate of growth in debt has remained at disturbingly high levels, although there are at least faint signs of a slackening in the rate of debt creation after a burst around the turn of the year. The declines in interest rates also clearly helped induce the general public to increase its holdings of its most liquid assets, including demand deposits and NOW accounts included in the narrow measure of the money supply, M1. That reaction was undoubtedly amplified by the fact that interest is paid on NOW accounts, which are now the favored form in which transaction balances are held by individuals. With interest rate spreads currently quite narrow between NOW accounts and other liquid assets, those accounts no doubt have served increasingly as a repository for liquid savings as well as for money held for transactions purposes.

Similarly, there are some indications of a greater willingness of businesses to hold demand deposits at a time of lower interest rates, partly because, with interest rates down, a larger balance is necessary to compensate banks for a given amount of services. To some extent, an environment of more stable prices may also be encouraging larger money holdings.

GROWTH OF M1

None of that was predictable with any precision, and the rate of growth in M1, which ran at almost 13 percent over the first half of the year, was far above the FOMC's target range. Action to restrain that growth within the target range—which would have required reducing the provision of reserves and a significant increase in pressures on bank reserve positions—was not deemed desirable in the light of other important considerations.

One of those considerations was that growth in the broader measures of money—M2 and M3—remained well within their respective target ranges of 6 to 9 percent, ending the second quarter close to their midpoints. That and other evidence suggested that much of the growth of M1 reflected a shifting of the composition of liquid assets rather than excessive, and potentially highly inflationary, money creation. That judgment was, of course, reinforced by the moderate rate of growth for the economy overall, the absence of indications of a strong acceleration as the year progressed, evidence of greater stability in prices of manufactured goods, and declining commodity prices.

In looking ahead, the Committee decided to retain the existing ranges of 6 to 9 percent for M2 and M3 this year. The range of 3 to 8 percent set for M1 early in the year was not recalibrated because of the uncertainties as to the behavior of that aggregate at present. Certainly the inflationary potential of excessive money growth remains a matter of concern. But in current circumstances, the Committee decided that the significance of changes in M1 could only be judged in the context of movements in the broader aggregates, and against the background of movements in interest rates and the economy generally. Taking account of those factors, growth in excess of the target established at the start of the year will be acceptable.

In circumstances of greater economic, price, and interest rate stability, more predictable relationships between M1 and the economy may reemerge over time, although the trend of M1 velocity—the ratio between GNP and M1— will likely be different than earlier in the postwar period. However, a firm conclusion concerning the nature and stability of future velocity characteristics may take years of experience in the new institutional and economic setting. For the time being, in looking to next year, the Committee set out a highly tentative range of M1 growth of 3 to 8 percent on the assumption that velocity changes will be within the range of most postwar experience. However, that judgment—and indeed the weight to be given any M1 range for 1987—will be carefully reviewed at the start of next year.

The tentative 1987 ranges for M2 and M3 were lowered by one-half percentage point to 5½ to 8½ percent. That modest reduction, consistent with the long-term objective of achieving a rate of monetary growth compatible with price stability, is judged to be entirely compatible with a somewhat greater rate of economic growth next year, provided that growth is not accompanied by a marked increase in inflationary pressures.

The actual price statistics for some months have, of course, reflected the precipitous drop in the price of oil, and consumer prices have dropped slightly this year. But equally clearly, the price of oil will not continue falling so fast, and at some point could well rise again. More predictably, the large depreciation of the dollar will bring in its wake an increase in import prices of manufactured goods. That impact has been moderated so far by the narrowing of the earlier wide profit margins of many of those exporting to us and by the availability of imports from developing countries, few of which have had any appreciable appreciation of their currencies vis-a-vis the dollar.

The rate of increase in costs of housing and of many services, which account for a large proportion of the economy, has decelerated little if at all in recent years. With demand strong, measured productivity gains limited, and compensation increases in service occupations continuing to average 4½ percent or more, those areas continue to lend a chronic inflationary bias to the general price level.

Those underlying forces are reflected in the projection of FOMC members and Reserve bank presidents that the overall inflation rate is likely to be somewhat higher next year. That prospect underscores the need for vigilance in the conduct of monetary policy. We want to assure maintenance of the remarkable progress toward stability as the economy grows more strongly and as a large amount of resources are shifted back to manufacturing industries as our trade balance improves. Without such assurance, there would be no firm basis for expecting the level of interest rates to remain for long at lower levels or to decline further.

EMPHASIS ON STRONGER TRADE BALANCE

In looking toward growth in the 3 to 3½ percent range next year, considerable emphasis was placed by committee members on the potential contribution to that growth of a stronger trade balance. As I emphasized earlier, that shift, if it is to take place in the context of sustained and stronger world growth, will require appropriately complementary policies here and abroad. Significant progress toward dealing with our own budget deficit seems to me a key ingredient in that overall policy mix.

The timing of another important domestic policy instrument—discount rate cuts—has been influenced by international financial and exchange rate considerations. A substantial realinement of the excessively strong dollar exchange rate has been a necessary and constructive part of achieving the necessary adjustment in external trade. But there are clear dangers in placing excessive weight on that approach.

History demonstrates all too clearly that a kind of self-reinforcing cascading depreciation of a nation's currency, undermining confidence and carrying values below equilibrium levels, is not in that nation's interest or that of its trading partners. Among other things, such a movement of the dollar now could transmit strong inflationary pressures to the United States and inhibit the free flow of capital from abroad at reasonable interest rates. Moreover, other countries would find it more difficult to sustain their forward momentum.

In the light of all these considerations, the discount rate reductions in March and April were timed to coincide with similar changes by one or more other key countries, minimizing any impact on the exchange markets and consistent with the desirability of some reduction in interest rates in the industrialized world generally.

Experience over the first half of 1986 underscored the difficulty—I would say the impossibility—of conducting monetary policy in current circumstances according to one or two simple, preset criteria. For instance, the rapid growth of debt and M1 clearly bear watching because of the potential for aggravating the vulnerability of the financial structure to adversity and because of the inflationary potential. However, the weight of the evidence strongly suggests that M1 alone during this period of economic and institutional transition is not today a reliable measure of future price pressures—or indeed a good short-term leading indicator of business activity. The more restrained performance of the broader aggregates, as well as the performance of the economy and prices themselves, point in a different direction.

At the same time, pressures on the oil industry, agriculture, and parts of manufacturing and the more general disinflationary process are reflected in strains on some depository institutions. Those strains emphasize the importance of dealing with factors more directly under the control of lenders themselves: excessive leveraging of borrowers and loose credit standards. A broad array of approaches by the supervisory and regulatory authorities has been necessary to deal with the particular points of pressure in a manner consistent with the stability of the entire fabric of financial institutions and markets.

LEGISLATIVE DIRECTION IN THE FINANCIAL SYSTEM

The present situation certainly makes all the more pointed the need to provide a stronger sense of legislative direction about the evolution of the financial system over time. There are also urgent specific pieces of legislation before you to permit the FDIC and the Federal Reserve to facilitate interstate acquisitions of failed or failing banks and to supplement the resources of the FSLIC.

The difficulties of some financial institutions are one specific example of economic problems that cannot be effectively dealt with by monetary policy alone. It is indeed a strength of monetary policy that it can respond flexibly to changing circumstances. But it is equally true that that single, broad-brush policy instrument cannot, at one and the same time, be called upon to stimulate the economy, protect the dollar, restrain excessive debt creation, and shift resources away from consumption and back into investment, manufacturing and exports—as desirable and important as all those goals may be.

Events of recent years have also heavily underscored how cumbersome fiscal policy can be, and the difficulties of achieving political consensus on such matters as tax reform and the appropriate legislative framework for financial institutions. On an international scale, achieving consensus on appropriate action can be still more difficult.

We have nonetheless come a long way toward restoring growth and stability in this decade. But my sense is that all that progress is in growing jeopardy unless we act—we in the United States, we in the industrialized world, and we in the world as a whole—in mutually supportive ways.

The main directions of that effort seem to me clear enough. The Gramm-Rudman-Hollings legislation is an expression of the sense of urgency surrounding our budgetary effort in the United States. The rest of the industrial world needs to achieve and maintain a momentum of home-grown expansion. With strong national and international leadership—and with the cooperation of private and public lenders—a constructive resolution of the economic crisis in Mexico can point the way to a wider resolution of the debt problem in a context of growth.

Hard as it may be to carry through on those efforts, that is what needs to be done if the imbalances in the economy are to be effectively addressed. Then we will have a really solid base for sustaining the momentum of growth and the progress toward stability in the years ahead. Certainly, the Federal Reserve will play its part in that effort.

[The complete prepared statement follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

July 23, 1986

I appreciate the opportunity to report once again on the conduct of monetary policy. I would first like to place that matter in the larger context of the performance of the United States and the world economy.

As you know, there have been marked contrasts in the economic performance of different sectors and regions of this country. Consumption has been strongly maintained, and there have been large increases in employment in the broad service sector. Housing is being built at a high rate. But industrial activity and business investment, which had leveled off last year, have declined over the last six months, and the agricultural and energy industries are under strong pressure. As a consequence activity in some areas of the country has advanced rather strongly, while severe adjustments are taking place in the energy and agricultural belts.

The net result is that the overall economic growth rate in the United States moderated to about 3 percent through 1985 and early 1986, and apparently slackened further in the second quarter of this year. Moreover, growth in other major industrialized countries remained slower than in the U.S. during 1985 and the early part of this year.

Throughout this period, sizable increases in employment have continued in this country; the unemployment rate has remained generally at a little over 7 percent and, relative to the size of the working age population, more people are employed than ever before recorded. In Europe, unemployment has also remained relatively steady, but at much higher levels.

After more than three years of economic expansion, the process of disinflation has continued, reinforced for the time being by sharply lower prices of oil, by far the most important commodity. With industrial prices steady, the average level of wholesale prices has been declining here, and even faster in key countries abroad whose currencies have been sharply appreciating relative to the dollar. Interest rates here and abroad have also declined appreciably, reflecting both the sense of progress against inflation and the fact that growth has been proceeding well within capacity restraints.

The large decline in U.S. interest rates and the sharply higher stock market over the past year suggest the cost of capital has declined. The fall in oil prices has helped bolster the real income of consumers. Meanwhile, the substantial depreciation of the dollar has placed our industry in a decidedly better competitive position vis-a-vis other industrial countries. As many have suggested, these underlying forces should help sustain an economic expansion that has already lasted longer than most.

But I would be remiss in failing to emphasize much less satisfactory aspects of the U.S. and world economic situation. There can be no evading the fact that some fundamental economic adjustments must be made within our economy in the months and years ahead.

The clear challenge is to find the ways and means to work through those adjustments in a context of sustained growth while also consolidating and retaining the progress toward price stability. The conduct of U.S. monetary policy is obviously relevant to that process. But that single policy instrument cannot itself provide the answer. Complementary approaches in the fiscal, trade and other policies of this country, and in the approaches of other countries, will be required as well. The hard fact is that, while the need for complementary actions to achieve the necessary adjustments in the United States and world economy seems to be more widely recognized, progress in coordinating action toward those aims has been limited.

Disequilibrium in the Industrial World

Some obvious imbalances have developed in the economies of the industrialized world. That is evident most of all in the enormous deficit in our external trade and current accounts, and in the counterpart surpluses of a few other countries. Unless dealt with effectively and constructively,

growing market and political pressures will, sooner or later, inevitably have much more disturbing consequences.

The problem first clearly emerged some time ago. The powerful thrust of the strong U.S. economic expansion in 1983 and 1984 had spilled out abroad in the form of sharply rising imports, aided and abetted by the exceptional strength of the dollar internationally. There were, for awhile, benefits on all sides. At a time of slack demand at home, exports to us helped Europe and Japan to restore and maintain their growth. The United States also absorbed a disproportionate share of the necessary external adjustment efforts by the heavily indebted countries of Latin America. Those countries have sharply curtailed their imports since 1982, and they have become more competitive in markets for manufactured goods.

At the same time, the United States began to be the recipient of a growing flow of capital from abroad. That inflow, which pushed the dollar so high in the exchange markets until early 1985, had the practical effect of relieving potential pressures on our internal financial markets even in the face of the massive and growing federal deficit. Consequently, private investment and construction could expand. At the same time, the competitive pressure from imports encouraged strong cost-cutting and productivity efforts in the industrial sector. That has been one powerful factor accounting for the near stability of prices of manufactured goods over the past year or more.

We cannot, however, build a lasting foundation for sustained growth and stability on massive international disequilibrium -- huge and rising trade deficits in the United States and counterpart surpluses abroad. Nor can we count on satisfying indefinitely so much of our own needs for capital by drawing so heavily on the savings generated elsewhere in the world -- savings that have been so freely available in part only because internal growth in Europe and Japan has been relatively slow.

Today the imbalances and strains are clearly showing. The forward momentum of our economy has been sustained almost

entirely by consumer spending and housing construction, both of which have been accompanied by unsustainably heavy borrowing. Savings meanwhile have remained at a relatively low level, even by past U.S. standards. For more than a year, industrial production in the United States has not grown appreciably, and there has been some decline in 1986. The pace of business investment has slackene

Some of the relative weakness in industrial output and investment over the past six months can be attributed to temporary factors and to developments peculiar to the United States. For instance, some investment orders were speeded up late last year in anticipation of tax reform, and the debate on the nature of that reform has apparently led to some deferral of ordering this year. The boom in spending for computers has subsided and commercial construction, in response to large and growing vacancies of office space, is predictably declining. Probably much more important in recent months have been very sharp cutbacks in domestic oil exploration and investment, driving energy producing states into recession-like conditions and affecting production of steel and equipment elsewhere as well.

But a large part of the difficulty stems from the continuing imbalances in the world economy. On the average, growth rates in major European economies and Japan were about 3/4 percent less than the reduced growth path of the United States during 1985 and the first quarter of 1986. However, the more disturbing contrast lies in the source of that growth.

In the United States, the rate of growth in domestic demand, while slowing in the third year of expansion, continued to average about 3-3/4 percent through that period. Domestic demand growth in the industrialized countries of Europe and Japan was significantly less -- about 2-1/2 percent. In the early part of this year, when their exports slackened, those countries grew not at all.

The plain implication is that our overall GNP growth rate was reduced by continuing deterioration in our trade and current account balances. With our current account

deficit reaching a record $135 billion annual rate in the first quarter of this year, industrial production and investment were restrained. Meanwhile, foreign surpluses continued to build through much of the period, and as their exports have slowed, internal demand has not yet, in most of those countries, picked up the slack.

Prospects for investment and for manufacturing activity in the United States are heavily dependent on an improved trade outlook. The sharp decline in the dollar since its peak in early 1985 should help set the stage for such an improvement. There is evidence that U.S. producers find themselves in a stronger competitive position. However, the deterioration in actual trade in manufactured goods has slowed little.

The decline in the dollar is both relatively recent and from a very high level so the absence of a stronger response in trade so far is not entirely surprising. What is of concern is that the domestic markets of our major industrial competitors have remained so sluggish, raising a question as to the buoyancy of the markets for our exports and of their own growth prospects.

You are well aware that the present imbalance among industrial countries is reflected in strong protectionist pressures in the United States. Yet, as the President has so strongly emphasized, to abandon our tradition of relatively open markets would surely be to invite an unravelling of the international trading order. We would then have less trade and more inflation. With that, prospects for sustained growth both here and abroad would clearly be placed in jeopardy.

I know of the complaints about "unfair" trading practices of other countries. We need to deal with them energetically. But I also know the clear lesson of experience is that a protectionist retreat by the United States, the world's leading economic power, would invite recrimination and escalation. Certainly, the most effective and promising avenue for dealing with the trade complaints on all sides will be in the planned round of multilateral trade negotiations rather than in a tit-for-tat process of mutual retaliation.

Moreover, I believe it is demonstrable that, as a matter of relative importance, much more fundamental imbalances in the world economy than unfair trading practices are responsible for the present pattern of trade deficits and surpluses. Those underlying imbalances can only be dealt with by complementary economic policies, not protectionism.

Quite clearly it is in no one's interest -- not the United States or other countries -- that we seek better balance in our external accounts by deliberately restraining further our own growth rate. But it is also true that as things now stand, stronger domestically generated growth in the United States will not reduce the international imbalances. Taken alone, it would aggravate our trade deficit further, posing an even more difficult adjustment problem later.

As I suggested, the recent exchange rate changes can help us to escape that dilemma -- they should work to improve our trade position and reduce the surpluses of others. In fact, faced with a combination of appreciating currencies and slower growth in overseas markets, exporters in both Japan and some European countries are experiencing reduced profits and more sluggish orders from abroad. However, in the absence of offsetting internal sources of expansion, those same pressures could dampen their own prospects for growth.

That is one of several reasons we should not rely on exchange rate changes alone to produce the needed international adjustments in the world economy. Over a number of years, we in the United States will certainly need to shift more of our resources into exports, and into recovering domestic markets where import penetration has been so high. That, very broadly, implies relatively more growth in manufacturing; relatively less growth in services, in governmental spending, or in other sectors; and more savings and less borrowing. For some of the rest of the world, the opposite shift will need to be at work -- less reliance on exports, and more on domestic sources of growth.

Mucn still needs to be done to ease the way for those adjustments. For one thing, we in the United States are not

prepared for a really large improvement in our trade balance. Our financial markets remain dependent on the large capital inflows from abroad that are a necessary counterpart of our trade and current account deficits. Moreover, taken by itself, depreciation of our currency in an effort to redress the trade deficit poses a risk of renewed inflation.

Only as our huge federal deficit is cut can we comfortably contemplate less borrowing abroad and provide assurance against renewed inflation. Put another way, in a growing economy, reductions in the federal deficit will be necessary to release the real and financial resources necessary to improve our trading position in a way consistent with rising investment.

In a few foreign countries, such as Germany, some signs of stronger internal growth have appeared in recent months. But such signs are far from uniform among key countries abroad, and most projections of their growth for this year have been lowered, not raised, as exports have slowed.

With rising currencies and falling oil prices, some of those countries after years of effort have now successfully achieved virtual stability in consumer prices. Moreover, their wholesale prices have declined sharply and are appreciably lower than a year ago.

All of us -- and certainly this central banker -- can appreciate the importance of maintaining a broad framework of stability and appropriate financial disciplines to sustain that progress. What is at issue for some countries is their ability to achieve and maintain vigorous internal growth at a time of high unemployment and ample resources as external stimulus fades away, as it must if international equilibrium is to be restored. The appreciation of their currencies and the strong deflationary influences of low oil and other commodity prices would appear to offer a prime opportunity for reconciling those goals of domestic growth and stability.

The International Debt Problem

Four years after the international debt problem broke into our collective consciousness in 1982, when Mexico abruptly lost access to international credit markets, that threat to our

mutual prosperity remains. The renewed difficulties of the oil producing countries today should not, however, obscure the progress that has been made. Collectively, the heavily indebted countries of Latin America and elsewhere have made an enormous effort to adjust their external accounts; in fact in 1984 and 1985 they were in rough current account balance, in contrast to an aggregate deficit of about $50 billion in 1982.

To be sure, that effort for a time was accompanied by sharp lower imports, recession, and lower standards of living as they brought their spending more in line with their internal resources. But it is also true that many of those countries are again growing, in some cases with vigor, as is the case with the largest single debtor, Brazil. Helped by the reduction in world interest rates, external interest burdens have been reduced appreciably in some countries relative to exports or other measures of capacity to pay. A number of Latin American countries have also made striking progress in dealing with ingrained inflation for the first time in many years, in the process gaining political support. There has been considerable, if uneven, progress toward liberalizing their economic structures in ways that should encourage more growth and productivity over time.

In the midst of this progress, the sharp decline in oil prices over the past six months has had an enormous adverse impact on the oil-exporting heavily indebted countries -- Venezuela, Nigeria, Ecuador and Mexico. At current oil prices, for instance, Mexico would lose about a third of its 1985 exports, perhaps as much as 15 percent of its government revenues, and the equivalent of some 5 percent of its GNP. Inevitably, that situation poses a new and severe challenge for Mexico -- a challenge that will require strong new efforts to make the necessary economic adjustments and to improve the structure of their economy. There is no large cushion of external reserves to buffer the shock. Consequently, a large amount of financial resources will have to be marshalled from abroad to help ease the transition, to maintain continuity in debt service, and to provide a solid base for renewed growth.

That combination of adjustment, structural change, and appropriate financing is, indeed, the essence of the approach announced by the Mexican Government earlier this week. In

cooperation with the IMF and the World Bank, Mexico is undertaking a wide range of efforts to deal with both its short- and longer-range economic problems. To my mind, their efforts, in the midst of crisis to move toward a more open, competitive economy, are particularly encouraging. They have joined GATT, import restrictions are being rationalized and liberalized, a good many state-owned enterprises are being made available for sale (or, if too inefficient, shut down), subsidies are being reduced and eliminated, and procedures for approving foreign investment eased. If carried through effectively, those measures promise to work toward fundamental improvement in the efficiency, competitiveness, and creditworthiness of the Mexican economy, thereby enhancing prospects for longer-term growth.

Today, that country is in recession. But the program clearly contemplates economic recovery in 1987 and 1988. Certainly, sizable amounts of financing from abroad will be required to support that effort. About half of that can be committed by the IMF, the World Bank, and the Inter-American Development Bank. But Mexico is calling upon commercial banks, with so much already at stake, to play a large role as well.

In assessing that situation, I would note that the Mexican exposure of commercial banks appears not to have increased for some 18 months. Indeed, there has been little net new lending to Latin America as a whole over the past year.

Taking the entire period since mid-1982, the exposure of American banks to the heavily indebted countries of Latin America relative to their capital has declined appreciably. That ratio fell from about 120 percent of the capital of lending banks to less than 75 percent at the end of last year, a decline of 38 percent. No doubt, there has been a further reduction by now.

Those exposures, in relative terms, are actually considerably less than in 1977 when the data were first collected. For some time, the pace of lending has, in fact,

been well below that contemplated by Secretary Baker when he set out a framework for a growth-oriented approach toward the international debt problem at the IMF meetings last autumn.

That initiative -- essentially contemplating a combination of strong adjustment efforts and structural reform by the indebted countries with reasonably assured financing by international institutions and private banks -- is now being tested. It is being tested in difficult circumstances not foreseen at the time -- the sharp break in oil prices. But the basic community of interests among borrowers and lenders -- and the world at large -- in a coherent, cooperative approach is as strong as ever.

The debtor countries themselves have an enormous stake in maintaining their creditworthiness and in seeking solutions in the framework of open, competitive markets. We all have a strong interest in international financial order -- all the more when there are other points of strain in the banking system. And, of course, relationships beyond the purely economic are at stake, for the United States most of all.

The challenge is large, but with cooperation, also manageable. Indeed, the same oil price decline that has undermined the budgetary and trading position of Mexico and other large oil exporters has relieved the pressure on those importing oil. Interest rates have declined. A number of borrowing countries will require significantly less, rather than more, financing than was contemplated a year ago. Given the enormous progress made in adjusting external positions, most of the borrowers can look toward more balanced expansion in their imports and exports as they grow -- among other things, providing renewed opportunities for American exporters.

But I must also emphasize one essential ingredient for success beyond the capacity of the indebted countries to manage. Only a stable, growing world economy, with markets open to the developing world, can provide an environment conducive to economic expansion, more normal interest rates, and orderly debt service by the borrowers. That ingredient is plainly the

responsibility of the industrialized world alone. It is one of the reasons why we must collectively deal with the obvious imbalances among us.

Monetary Policy in 1986

These larger issues were the background against which the Federal Reserve has conducted monetary policy in 1986 and reviewed its objectives for growth in money and credit this year and next. The results of the review by the Federal Open Market Committee of target ranges for money and credit for 1986 and tentative ranges for 1987 were discussed in the Humphrey-Hawkins Report published and sent to the Committee at the end of last week. That report also sets out projections for real activity and prices of FOMC members and Reserve Bank presidents.

As indicated in the Report, the posture of monetary policy remained broadly accommodative over the past six months. The discount rate has been reduced in three steps this year by 1-1/2 percent, in part responding to and in part facilitating declines in short-term interest rates of similar magnitude. Long-term interest rates also moved lower, extending the sharper drops in the second half of last year. The general structure of interest rates is now as low as at any time since 1977.

The reductions in interest rates in 1985 and 1986 have clearly helped support the more interest-sensitive sectors of the economy, reflected in part in the highest level of housing starts since the late 1970s. The declines have also helped ease the debt servicing costs of businesses, farmers, developing countries and the U.S. Government itself.

On the other side of the ledger, as interest rates have declined, the rate of growth in debt has remained at disturbingly high levels, although there are at least faint signs of a slackening in the rate of debt creation after a burst around the turn of the year. The declines in interest rates also clearly helped induce the general public to increase its holdings of its most liquid assets, including demand deposits and NOW accounts included in the narrow measure of the money supply, M1. That reaction

was undoubtedly amplified by the fact that interest is paid on NOW accounts, which are now the favored form in which transaction balances are held by individuals. With interest rate spreads currently quite narrow between NOW accounts and other liquid assets, those accounts no doubt have served increasingly as a repository for liquid savings as well as for money held for transactions purposes.

Similarly, there are some indications of a greater willingness of businesses to hold demand deposits at a time of lower interest rates, partly because, with interest rates down, a larger balance is necessary to compensate banks for a given amount of services. To some extent, an environment of more stable prices may also be encouraging larger money holdings.

None of that was predictable with any precision, and the rate of growth in M1, which ran at almost 13 percent over the first half of the year, was far above the FOMC's target range. Action to restrain that growth within the target range -- which would have required reducing the provision of reserves and a significant increase in pressures on bank reserve positions -- was not deemed desirable in the light of other important considerations.

One of those considerations was that growth in the broader measures of money -- M2 and M3 -- remained well within their respective target ranges of 6-9 percent, ending the second quarter close to their mid-points. That and other evidence suggested that much of the growth of M1 reflected a shifting of the composition of liquid assets rather than excessive, and potentially highly inflationary, money creation. That judgment was, of course, reinforced by the moderate rate of growth for the economy overall, the absence of indications of a strong acceleration as the year progressed, evidence of greater stability in prices of manufactured goods, and declining commodity prices.

In looking ahead, the Committee decided to retain the existing ranges of 6-9 percent for M2 and M3 this year. The

range of 3-8 percent set for M1 early in the year was not recalibrated because of the uncertainties as to the behavior of that aggregate at present. Certainly the inflationary potential of excessive money growth remains a matter of concern. But in current circumstances, the Committee decided that the significance of changes in M1 could only be judged in the context of movements in the broader aggregates, and against the background of movements in interest rates and the economy generally. Taking account of those factors, growth in excess of the target established at the start of the year will be acceptable.

In circumstances of greater economic, price, and interest rate stability, more predictable relationships between M1 and the economy may reemerge over time, although the trend of M1 velocity -- the ratio between GNP and M1 -- will likely be different than earlier in the postwar period. However, a firm conclusion concerning the nature and stability of future velocity characteristics may take years of experience in the new institutional and economic setting. For the time being, in looking to next year, the Committee set out a highly tentative range of M1 growth of 3-8 percent on the assumption that velocity changes will be within the range of most postwar experience. However, that judgment -- and indeed the weight to be given any M1 range for 1987 -- will be carefully reviewed at the start of next year.

The tentative 1987 ranges for M2 and M3 were lowered by one-half percentage point to 5-1/2 - 8-1/2 percent. That modest reduction, consistent with the long-term objective of achieving a rate of monetary growth compatible with price stability, is judged to be entirely compatible with a somewhat greater rate of economic growth next year, provided that growth is not accompanied by a marked increase in inflationary pressures.

The actual price statistics for some months have, of course, reflected the precipitous drop in the price of oil, and consumer prices have dropped slightly this year. But equally clearly, the price of oil will not continue falling so fast, and at some point could well rise again. More

predictably, the large depreciation of the dollar will bring in its wake an increase in import prices of manufactured goods. That impact has been moderated so far by the narrowing of the earlier wide profit margins of many of those exporting to us and by the availability of imports from developing countries, few of which have had any appreciable appreciation of their currencies vis-a-vis the dollar.

The rate of increase in costs of housing and of many services, which account for a large proportion of the economy, has decelerated little if at all in recent years. With demand strong, measured productivity gains limited, and compensation increases in service occupations continuing to average 4-1/2 percent or more, those areas continue to lend a chronic inflationary bias to the general price level.

Those underlying forces are reflected in the projection of FOMC members and Reserve Bank presidents that the overall inflation rate is likely to be somewhat higher next year. That prospect underscores the need for vigilance in the conduct of monetary policy. We want to assure maintenance of the remarkable progress toward stability as the economy grows more strongly and as a large amount of resources are shifted back to manufacturing industries as our trade balance improves. Without such assurance, there would be no firm basis for expecting the level of interest rates to remain for long at lower levels or to decline further.

In looking toward growth in the 3-3 1/2 percent range next year, considerable emphasis was placed by Committee members on the potential contribution to that growth of a stronger trade balance. As I emphasized earlier, that shift, if it is to take place in the context of sustained and stronger world growth, will require appropriately complementary policies here and abroad. Significant progress toward dealing with our own budget deficit seems to me a key ingredient in that overall policy "mix."

The timing of another important domestic policy instrument -- discount rate cuts -- has been influenced by international financial and exchange rate considerations. A substantial realignment of the excessively strong dollar exchange rate has been a necessary and constructive part of achieving the necessary adjustment in external trade. But there are clear dangers in placing excessive weight on that approach.

History demonstrates all too clearly that a kind of self-reinforcing cascading depreciation of a nation's currency, undermining confidence and carrying values below equilibrium levels, is not in that nation's interest or that of its trading partners. Among other things, such a movement of the dollar now could transmit strong inflationary pressures to the United States and inhibit the free flow of capital from abroad at reasonable interest rates. Moreover, other countries would find it more difficult to sustain their forward momentum.

In the light of all these considerations, the discount rate reductions in March and April were timed to coincide with similar changes by one or more other key countries, minimizing any impact on the exchange markets and consistent with the desirability of some reduction in interest rates in the industrialized world generally.

Some Lessons of Recent Experience

Experience over the first half of 1986 underscored the difficulty -- I would say the impossibility -- of conducting monetary policy in current circumstances according to one or two simple, pre-set criteria. For instance, the rapid growth of debt and M1 clearly bear watching because of the potential for aggravating the vulnerability of the financial structure to adversity and because of the inflationary potential. however, the weight of the evidence strongly suggests that M1 alone during this period of economic and institutional transition is not today a reliable measure of future price pressures (or indeed a good short-term "leading indicator" of business activity). The more restrained performance of the broader aggregates, as well as the performance of the economy and prices themselves, point in a different direction.

At the same time pressures on the [illegible] industry, agriculture, and parts of manufacturing and the more general disinflationary process are reflected in strains on some depository institutions. Those strains emphasize the importance of dealing with factors more directly under the control of lenders themselves: excessive leveraging of borrowers and loose credit standards. A broad array of approaches by the supervisory and regulatory authorities has been necessary to deal with the particular points of pressure in a manner consistent with the stability of the entire fabric of financial institutions and markets.

The present situation certainly makes all the more pointed the need to provide a stronger sense of legislative direction about the evolution of the financial system over time. There are also urgent specific pieces of legislation before you to permit the FDIC and the Federal Reserve to facilitate interstate acquisitions of failed or failing banks and to supplement the resources of the FSLIC.

The difficulties of some financial institutions are one specific example of economic problems that cannot be effectively dealt with by monetary policy alone. It is indeed a strength of monetary policy that it can respond flexibly to changing circumstances. But it is equally true that that single, broad-brush policy instrument cannot, at one and the same time, be called upon to stimulate the economy, protect the dollar, restrain excessive debt creation, and shift resources away from consumption and back into investment, manufacturing and exports -- as desirable and important as all those goals may be.

Events of recent years have also heavily underscored how cumbersome fiscal policy can be, and the difficulties of achieving political consensus on such matters as tax reform and the appropriate legislative framework for financial

institutions. On an international scale, achieving consensus on appropriate action can be still more difficult.

We have nonetheless come a long way toward restoring growth and stability in this decade. But my sense is that all that progress is in growing jeopardy unless we act -- we in the United States, we in the industrialized world, and we in the world as a whole -- in mutually supportive ways.

The main directions of that effort seem to me clear enough. The Gramm-Rudman-Hollings legislation is an expression of the sense of urgency surrounding our budgetary effort in the United States. The rest of the industrial world needs to achieve and maintain a momentum of "home-grown" expansion. With strong national and international leadership -- and with the cooperation of private and public lenders -- a constructive resolution of the economic crisis in Mexico can point the way to a wider resolution of the debt problem in a context of growth.

Hard as it may be to carry through on those efforts, that is what needs to be done if the imbalances in the economy are to be effectively addressed. Then we will have a really solid base for sustaining the momentum of growth and the progress toward stability in the years ahead. Certainly, the Federal Reserve will play its part in that effort.

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POSSIBLE LOAN LOSS RESERVE DEDUCTIBILITY

The **Chairman**. Thank you, Mr. Chairman.

Mr. Chairman, as I'm sure you are well aware, the House version of the tax bill would repeal the deduction of contributions to loan loss reserves by banks. Previously this year you have been opposed to that provision. I am opposed to it. It makes no sense to me at all, whatever else we're doing with tax reform, not at a time when we are constantly talking about safety and soundness and the domestic as well as international problems of many financial institutions in this country and talking about encouraging them to increase capital and loan loss reserves.

Do you still feel that it would not make a great deal of sense to take away that incentive to increase loan loss reserves for safety and soundness at this time?

Mr. **Volcker**. Yes, I do, Mr. Chairman. I have expressed my opinion on that earlier to the Senate committee. I think on that point, and on the somewhat related point of the foreign tax credit provisions where a long transition is provided for loans to the heavily indebted countries, I think the Senate bill dealt with those areas in a responsible way, particularly given existing problems to which you refer.

The **Chairman**. I'm sure before we get through with all the questions you will be asked every facet of your opinions on monetary policy and the discount rate in particular, so I will not go into that. I am interested, however, in your feelings on what the uncertainties of our current tax legislation are doing in contributing to the problems of the economy.

I am not asking for your opinions on various parts of the tax reform bill, but it seems to me that, since I have been in the Senate, it has been very difficult for people to make business decisions because we have changed the tax laws so often and it is so difficult to forecast what Congress is going to do. We have gone through nearly a year now of hearings in both the House and the Senate and, at least in my opinion, it has caused a lot of disruption in the market, not because of what we ultimately may do but because of the lack of understanding of what we may do and, of course, the conference will probably continue for several weeks.

Do you feel that getting away from the M's and the discount rates and all of that, that merely the uncertainty that Congress is projecting on tax legislation has a part in the difficulties in the economy right now?

Mr. **Volcker**. Well, you asked a question that is obviously impossible to identify statistically or quantitatively, but I share the feeling that you expressed. In talking with businessmen and others, you do see evidence that the uncertainty itself has led to some deferral of ordering, simply on the basis that we might as well see what the shape of the bill is when it comes out in the end before ordering things that don't necessarily have to be ordered and put in place immediately.

So I think it has had an effect. Whether there is also an effect, or the extent to which there is an additional effect, from the standpoint of both bills to different degrees removing some investment incentives is also impossible to identify. But I agree with you that the uncertainty alone appears to have led to some deferral and has probably been an identifiable influence on the rather weak ordering figures that we had for investment over the past 4, 5, or 6 months.

The CHAIRMAN. It's interesting in the time I've been in the Senate I've never seen such a steamroller or train brushing every obstacle aside without regard to some of the merits or demerits of the bill itself.

One thing that I think has been overlooked that I've heard several people comment on is the fact that doing away with so-called loopholes or preferences potentially occurs on January 1, 1987, but the lower rates don't occur until July, and that has not been widely discussed. In fact, a lot of people may not understand that that is the case, precipitating considerably higher taxes for a lot of people and businesses next year.

Do you also feel that that possibly has an impact on the economy and the perceptions of what is taking place?

Mr. VOLCKER. Perhaps less so, because I take the view that a reduction in the deficit is important in achieving a better-balanced economy. Those transitional revenue increases, I suppose, would call for——

The CHAIRMAN. Well, but we're not using them. Senator Dole suggested that at the beginning and was immediately jumped on by everybody arguing that we don't play that game, don't take that $22 billion and use it as a credit.

CREDITS FROM TAX REFORM

Mr. VOLCKER. Well, I understand the argument about using it as a credit or not using it as a credit against Gramm-Rudman, but if it passes that way it's there and will have the effect presumably of reducing the deficit somewhat in the short run, not in the long run. It's a very temporary effect, but I think it does push in the direction of moving the deficit lower.

Now if you've got sufficient progress on the deficit without counting that, then obviously that could be changed without taking into account the deficit implications. But that's a big if, I guess.

The CHAIRMAN. Well, you and I know, as we've discussed many times in this committee the importance of perceptions. We play scoring games with OMB and what we're going to find out is that neither OMB nor CBO, none of them, the Congress, the President, are going to be right on their estimates.

Mr. VOLCKER. I think that's a fair assumption.

The CHAIRMAN. That's a very fair assessment. But nevertheless, it does have an impact if we do not score it. If we don't show it as a reduction, I frankly would be more pragmatic and say, look, we play 1-year games at a time anyway, so why not take credit for the $22 billion and help solve our problem because this ridiculousness of 5-year projections in this body is so absurd that we play the 1-year game at a time anyway, so why not be honest about it and take credit for it and worry about the 1988 budget when it comes.

I think we should take a longer look but we never have in the 12 years that I've been here.

Mr. **Volcker**. Well, I think I would get very worried if you took credit for it and didn't take the longer look. That, of course, is a question of presentation. But as I understand it, the implication of that bill in raising revenues in the first year is that it loses revenues thereafter. That would have to be taken account of too. You can't play it one way.

The **Chairman**. But at least it is there and it is real compared to the mirrors and smoke that we are playing with the current budget resolution and you wait and see, that thing is not going to be $144 billion; that is going to be $10 or $15 billion more than that. We are playing with a sham in that budget resolution.

Mr. **Volcker**. Whether it's there or not, of course, depends on how it comes out of the conference committee, too.

The **Chairman**. A great deal of interest has focused on the fact that the Fed pointed to the low level of commodity prices in explaining the July 10 reduction in the discount rate. Doesn't focusing on the level of commodity prices risk confusing relative prices with the overall price level?

Mr. **Volcker**. Well, I'm glad you raised that question. I saw some attention directed toward the fact that commodity prices were mentioned in that announcement, so I went back and looked at a little history.

And commodity prices, I think, have been mentioned in the last four out of five announcements of the discount rate change and were mentioned back in 1979 in one of the first discount rate changes after I took office. So it's not exactly a new departure to take account of commodity prices in those announcements.

But I would answer your question yes and no. Commodity prices—as the frequency with which we mentioned them suggests—is one sensitive indicator of the condition of the economy, and the world economy, and to some degree price trends more generally. But certainly commodity prices fluctuate much more than the basic trend of consumer or wholesale prices and I think you could be misled by assuming that commodity prices give you the whole picture in terms of inflationary or deflationary forces in the economy.

COOPERATION OF TRADING PARTNERS

The **Chairman**. You have emphasized not only today but in previous weeks and when the second discount rate cut of the year occurred the need for cooperation by some of our friends and allies, particularly West Germany and Japan. They appear to be again resisting any reductions.

Can you give us any reasons why they are not willing to attempt to solve some of the problems in their own economies?

Mr. **Volcker**. Well, I suppose they would see it somewhat differently than failing to solve the problems in their own economies and there may be different perspectives. But I think in both of those countries, in a general way, they have worked hard to achieve stability in the inflationary sector. In varying degrees, they have had some optimism about the strength of their economies. In both cases, monetary aggregates have been rising somewhat faster than they had announced or intended early in the year, although the deviation is not very large.

And when they look at their internal situations, they reach the judgment that they reached. It is also true that the economic growth rate in Europe generally, and in Germany and Japan in the early part of the year, was not up to expectations. In fact, it was negative in those two countries. As I indicate in my statement, there is some early indications anyway of a considerable rebound in Germany during the current quarter.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, you have appeared before this committee testifying on this particular subject 14 times in the last 7 years, is that about right?

Mr. VOLCKER. I don't know; 7 years, twice a year, that must make 14 times.

CONTROL OF INFLATION

Senator PROXMIRE. Well, that's the way I count. At any rate, it seems to me that there's been somewhat less emphasis by you than usual on inflation. And as I tried to point out in my opening remarks, we have deficits now that have gone on for 5 years at an enormous rate. In spite of Senator Mattingly's statement, the fact is the 1986 deficit is going to be the biggest ever. The first year Gramm-Rudman is in effect, obviously that's not doing much about it. In my judgment, we'll have another $200 billion deficit in 1987 in all likelihood.

Furthermore, the money supply is increasing more rapidly than I can ever remember it increasing. The decline in the value of the dollar and the likely end of the oil price drop, which you cite as a matter of fact in your statement, will have an inflationary effect. Have you really stopped worrying about inflation?

Mr. VOLCKER. I never stop worrying about inflation. I think when you stop worrying about inflation is when you get it. It had better be a constant worry.

Senator PROXMIRE. Well, I'm glad to hear you say that, but when I look at your monetary policies it seems to me that there's less concern and, of course, in the short run the situation looks terrific. Here we have a situation where we have an excess of labor still. We have high unemployment, as you said, a big increase in jobs. We have 8.4 million people out of work. We have a surfeit of oil, a surfeit of food. We have all kinds of reasons to argue that inflation is under control.

On the other hand, we have that monetary component—and as you know better than anybody in the world, the fact is that inflation is too much money chasing too few goods, there's no question about it, and we may be moving in that direction.

Mr. VOLCKER. Well, I think it's legitimate to raise concern about that and we look at it all the time. I expressed some concern in my statement, but you have to take it in the context of what else is going on in the economy at the moment. I suppose I want to look at that increase in the money supply pretty closely from that point of view and make whatever judgment seems appropriate. But looked at in a kind of medium-term perspective, it is that continuing pressure of the budget deficit. When we get through this period where we are immensely favored in inflationary terms by the oil price decline, when we look to the adjustment that we have to make in our external position, when we look to the consequences of a depreciating dollar down the road, there obviously are reasons to be concerned that the inflationary rate could speed up once again. And I think the best single piece of protection that we can have against that, in a kind of structural way, is to work to reduce the budgetary deficit and the demands that that places upon financial markets and the economy, as the trade situation gets better.

In fact, I would argue more fundamentally that the chances of the trade deficit getting better—and the chances of us dealing in that context with financial market problems—are not very good unless the budgetary deficit is reduced more or less in line with the reduction in the trade deficit.

INCREASED DEBT IN ALL SECTORS

Senator **Proxmire**. Now you properly are concerned and express your concern very strongly about too little savings and too much debt and the debt is particularly conspicuous. We have the highest personal debt ever. We have the highest corporate debt ever. We have the highest Federal debt, heaven knows, ever. As a matter of fact, corporate debt is even bigger than the Federal debt. Our savings are at an all-time low in relationship to income.

And yet the policy now of lower interest rates which all of us would like for many reasons tend to go in exactly the wrong direction as far as this is concerned.

Mr. **Volcker**. I agree with that.

Senator **Proxmire**. They discourage savings. They encourage debt. The one element that's keeping growth in the economy now is increased housing—increased government too, but increased housing.

Mr. **Volcker**. Increased consumption, too.

Senator **Proxmire**. Well, increased consumption expressed in housing starts primarily.

Mr. **Volcker**. Not just in housing starts. Consumption is pretty strong across the board.

Senator **Proxmire**. And that's because interest rates are low. So that we're following policies it seems to me that are going to continue to aggravate the situation, increase corporate, Federal, and personal debt, and discourage savings.

Mr. **Volcker**. It is one of those dilemmas that we face right now and it is a perfect illustration how monetary policy can't solve everything at the same time.

If you simply look at the factors that you were looking at, then I think the implication would be one thing. If you look at it in the context of total economic performance and other problems in the United States and around the world, you reach a different conclusion. And we have to balance those off.

Senator **Proxmire**. Now let me look at it from a different standpoint right away and meet myself coming the other way, but I think it's an immediate question for all of us.

Suppose the economy continues to slow further and we stagger along at a 1-percent or close to 1-percent level of growth or maybe even less, and we follow your prescription of reducing the deficit and somehow Gramm-Rudman comes out right and we do in fact cut spending.

Won't that have a direct predictable adverse effect on economic growth? Won't that tend to push us into a recession? It seems to me that we're in a position that's extraordinarily difficult now for that reason.

Mr. **Volcker**. I think the answer to that question—and what I try to say maybe too opaquely in my statement—is that the implications of that kind of a situation depend very much on what kind of a world economy we're living in. If we're living in an economy where we have a good economic expansion going in the rest of the world, I think that kind of a situation will be reflected in a rather pronounced and important change in our trade balance, which would be the best thing that could happen for us in terms of restoring a basic equilibrium in the world economy.

Senator **Proxmire**. That's a nice dream but we're not living in that kind of world and we probably won't be.

Mr. **Volcker**. Well, I'm not so sure about that. We can't solve all these problems by ourselves and there are very mixed indications abroad. But the indications are mixed and obviously there's always the opportunity for policy actions abroad.

But given a starting point of a $135 billion deficit in our current account and the importance of that in terms of progress in our manufacturing industry and in our investment, I simply do not think you can deal with, and project with any reasonability, the performance of our economy and the various risks that are involved without considering what kind of world environment we're living in. And that is the world we're living in.

DIFFERENCES IN TWO STATEMENTS

Senator **Proxmire**. Now you gave us two statements. One statement we got 24 hours in advance. The other statement we got just before we came in. And you made some interesting changes in them, particularly on page 31. On page 31 you made a statement in your original text that you deleted. You said:

> There is no escape from the fact that strains on depository institutions are not simply a possible threat for the future but a present reality.

And you deleted that.

And further down you made one other deletion. You said:

> Developments under control of the lenders themselves, even abused by some federally insured and protected depository institutions of their responsibility to employ their funds prudently free of conflicts of interest.

Was that deletion made at the request of the Treasury?

Mr. **Volcker**. No. I read it last night and I wanted to make sure that I had it in the proper perspective. The phrase that I took out was about "even abuse of the responsibility to lend funds prudently by federally insured depository institutions." We certainly see that, but I think it's relatively few institutions. I was afraid that statement was a little out of context. It was entirely at my own initiative in rereading the statement last night.

Senator PROXMIRE. Well, what did you have in mind by that?

Mr. VOLCKER. I'll give you two prime examples of what I had in mind—what went on in the States of Ohio and Maryland, and I think we are not entirely free of those same kinds of symptoms, particularly in some areas in the savings and loan industry.

Senator PROXMIRE. Now over the last 12 months the money supply as measured by M1 has grown by 12.8 percent, well in excess of the Fed's targets. That explosion in money growth is sometimes blamed on financial deregulation and lower interest rates. That is, as interest rates come down people shift their money from short-term liquid investments into NOW accounts. However, the demand deposit component of M1 has grown by nearly 10 percent over the last year. Of course, demand deposits pay zero interest.

As a result, why wouldn't it be just as accurate to conclude that the explosion in money growth is due to the Fed's decision to supply more money rather than an increase in the public demand for money?

Mr. VOLCKER. Well, it's always a chicken and an egg. You have supply and demand, and we certainly satisfied the demand. That is the sense in which our policy was accommodative. We satisfied that increase in demand that took place as interest rates declined based on the considerations I discussed in my statement. And you can say that the money supply would not have increased so much if we had been more restrictive in the provision of reserves. I agree with that. But we chose to be less restrictive in the overall context in which we were operating.

THIRD WORLD DEBT

Senator PROXMIRE. Now Senator Bradley has proposed a far-reaching alternative to the Baker plan for Third World debt relief, as I'm sure you know. Senator Bradley calls for a substantial writedown and rate reductions in the Third World debt on the part of U.S. banks. He argues that's the only way these debt-ridden countries are going to get back on their feet and resume normal economic growth.

What's your reaction to the Bradley proposal?

Mr. VOLCKER. Well, I'm obviously concerned about the same set of circumstances, broadly, that Senator Bradley is concerned with, and his approach in some of its elements is directly on point with the approach we have been taking. In the element of interest rate subsidies and writedowns, it obviously differs.

I do believe that that approach would be counterproductive, looking over a period of time in terms of restoring these countries to creditworthiness into the marketplace.

I would also point out that if you take the case of Mexico, for instance, and look at the relief that they would get in actual cash terms for their external position, from his plan it wouldn't be enough. Reducing the interest rates by 3 percent on bank debt in the case of Mexico would produce something under $2 billion a year. That's significantly less money than the banks are being asked to provide in the program that the Mexicans announced this week. Moreover, under a Bradley-type plan, it would be unreasonable to expect banks to lend additional money and he didn't call for that. So in that sense, I don't think it would work.

I think his kind of approach would necessarily lead to a quick generalization. However much he might want to shape it case by case, the politics simply wouldn't permit that.

Senator **Proxmire**. My time is up, Mr. Chairman.

The **Chairman**. Senator D'Amato.

TRADE IMBALANCES

Senator D'**Amato**. Thank you, Mr. Chairman.

Chairman Volcker, in your remarks that you prepared for the committee today, the second set of remarks received only this morning, you allude to the problems we are experiencing due to our trade imbalances. My question is, looking at the history, looking at our efforts to reduce the value of the dollar, and the limited success, if any success, in bringing that balance of payments down, how realistic do you believe it is that our trading partners will change their policies without any legislative action or other executive action?

Mr. **Volcker**. Well, you're talking about trade policies, a trading practices question rather than the size of an imbalance. They're not unrelated. But I think the best chance of addressing those problems does lie in multilateral trade negotiations. I know that's a difficult, anguishing process, but we shouldn't forget they have complaints about us, too.

Senator D'**Amato**. The Japanese should complain about us?

Mr. **Volcker**. I think——

Senator D'**Amato**. They steal our patents, intellectual property rights, systematically are adjudged guilty in the courts, say we're sorry, pay back penalties, continue the same thing, infringe on patents and then send the products here into the United States. Further, those harmed have limited recourse under the current legal system. At present, ever though your copyright may have been infringed or your patent stolen you must then demonstrate that there is substantial danger to the particular industry, before damages can be awarded. Despite the failure of the laws and trade policies pursued to date we hear, oh, yes, we're going to make changes. We've been waiting a long time for negotiations or other bilateral approaches to work. We wait in vain. It seems to me, absent any legislative action or some very real enforcement of present trade practices, the policies of the Japanese and others will not change because they lack any incentive to change.

And then you say, well, our best hope is bilateral——

Mr. **Volcker**. I was not suggesting the situation with respect to Japan either in policy or results was in balance. It obviously isn't.

Senator D'**Amato**. It isn't in balance?

Mr. **Volcker**. It's not in balance.

Senator D'**Amato**. OK. We agree.

Mr. **Volcker**. It clearly is widely out of balance, however you look at it. The question is how you best approach this problem in some of the very areas that you're talking about in copyrights and patents and so forth. It may be—and I don't want to get too deeply into an area that's outside my expertise—the kind of area that the best prospect for getting results is when you can bring a world consensus to bear on the problem.

Senator D'AMATO. Let me suggest that, absent possibly some strong legislation or other actions requiring reciprocity, the trade imbalance will continue unabated.

Mr. VOLCKER. Well, we do have laws and they ought to be enforced. I don't disagree with that. But you asked me where the emphasis should be at this point. I don't think we have exhausted all the other routes and as a matter of emphasis I think that's where it should be.

But let me not leave this question without reiterating something I said in the statement, that if one looks at our trade balance—I mean the actual quantitative results rather than the kinds of things that you're talking about that are important in their own right—I don't think there's any doubt that our total trade imbalance is more a matter of inconsistencies, lack of complementarity, imbalances in other policies. The contribution that trading practices themselves can make are not insignificant, but they don't account for a $135 billion trade deficit or anything like it.

AREA OF INTEREST RATES

Senator D'AMATO. Let me shift if I might, Chairman Volcker, to one other area, and that is the area of the interest rates and how you determine real and artificial rate cuts.

A hindsight question. The last cut it was a reduction of one-half of 1 percent. Now let me ask you, if you were to have perceived that the economic growth would have come in at the 1.2-percent level, might you have opted to make that cut in the discount rate an additional one-half percent?

Mr. VOLCKER. Well, we always debate those things. That figure was not terribly surprising and I don't want to overly emphasize one quarter's figure. While announcing 1.1 percent in the second quarter, the Commerce Department revised the first quarter upward by almost 1 percent. That second quarter figure was heavily influenced by two always volatile factors—inventories and the trade situation. These components are purely estimates, almost guesses at this point, because the Department doesn't have the data for the whole quarter. And what data they have is subject to revision.

WORSENING TRADE BALANCE

The reduction was in those two volatile items, where final demands were pretty well maintained during the quarter. One of those areas where the number was so adverse—the trade area—is an illustration of the underlying problem. That is an area that's been getting worse quarter after quarter by and large. It is an area that explains in very large degree the sluggishness of manufacturing business, the sluggishness of business investment.

So in that sense, I think that quarter's figure was very symptomatic of the underlying problem of the economy.

Senator D'AMATO. Do you see anything on the horizon that would give you reason for hope that the future will be any different than that which we have experienced in the past 6 months with regard to trade inbalances?

Mr. VOLCKER. We do have a big change in exchange rates vis-a-vis our industrial competitors and you would certainly expect that to have an effect but that takes time. That effect works all the more slowly if you don't have a buoyant world economy. So again to deal with your question, I think it is a question of what is the buoyancy of the rest of the world economy. If that's going to be very sluggish, it's going to be a tough process to see our trade balance improve, and particularly to see it improve in the context of world growth and prosperity. We don't want to see the trade balance improve in the midst of a recession here and abroad. We want to see it improve in the context of growth. And that depends on the strength of economic activity elsewhere in the world. That is our market.

Senator D'AMATO. Mr. Chairman, I am particularly pleased with the candor in which you address the questions on trade and trade policy because I couldn't agree with you more as it relates to the total problem in terms of economic growth, or more precisely, the recent lack of growth.

Having said that, I believe it is incumbent on this Congress to demonstrate more than its concern, but also put forth for debate and possible legislative enactment proposals that will deal with the kinds of practices that are totally unfair, that are predatory, that in some cases involve actual larceny. Recent judicial rulings that fail to redress the wrongs suffered by American manufacturers from the actions of our "trading partners" must be addressed by this Congress. Thieves must not escape with impugnity. The actual taking of people's property rights that they've invested millions and millions of dollars in, is not an offense that will not be deterred by paying, in many cases, only a relatively small fine. And that's what's been taking place and many Americans have been losing their jobs as a result.

I think it's time to say, because I see a lack of determination of this administration to deal with some of these difficult problems and say to so-called friends, "We're going to insist that there be fair trade, free trade has got to work both ways," and I don't believe that the American people have been dealt with fairly by many of our trading partners.

I would like to conclude with one other observation and that would be, Chairman Volcker, that I do believe, given the sluggishness of the economy at the very least, and given the trade problems that you have touched on, that I do think that a further discount rate reduction is needed to stimulate the economy. And I know that more than just this Senator will be anxiously watching the actions of the Fed and I hope they act sooner rather than later. I don't want to see the situation deteriorate more, nor do I suggest that a further interest reduction in and of itself is going to cure the problem. I think it might ease the situation for some and stimulate some economic growth.

I thank the Chairman for sharing his thoughts with us in as candid a manner as I've ever heard you express them. Thank you.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Chairman Volcker, in your statement on page 6 and in fact in all your remarks, you speak of massive international disequilibrium and your concern about it. A little further down you talk about imbalances and clearly showing strains.

WORLD ECONOMIC INTERDEPENDENCE

It seems to me, as I listened carefully to what you said, and the emphasis you gave it orally, as well as reading it beforehand, that it is your view that world economic interdependence has really grown dramatically in say the last 10 years for a lot of reasons. Is that a fair judgment?

Mr. VOLCKER. Well, I think it's been growing for a long time and it's certainly reached a high level and never before has the trade balance and changes in the trade balance loomed so large in terms of our own domestic performance.

Senator RIEGLE. Well, as a measure of that, the latest estimates of the trade balance that I've seen indicate that it may be up in the range of $165 billion. I'm just talking about the merchandise trade deficit. The current account deficit might be in the range of $135 billion. The $135 billion figure is what's taken us up to the No. 1 debtor nation in the world, and in a way it means that we go deeper in debt to the rest of the world about $1 billion every 2½ days. I don't think the public is yet accustomed to thinking in those terms because it's a dramatic change in circumstance.

Mr. VOLCKER. I think your arithmetic is correct, unfortunately.

Senator RIEGLE. I find to be a worrisome reality the meaning of that fact, having gone from a creditor nation consistently every year from 1914 until about 1½ year ago, to now having gone to the top of the debtor nation list and adding to it to the tune of $1 billion every 2½ days.

Now I got the clear sense from what you're saying now that the nature and the mix of these problems is such that we can't solve them by ourselves even if we take the right policy steps. In other words, we've got to coordinate those right policy steps particularly our Western allies. Is that right?

Mr. VOLCKER. Coordinate in the sense of broadly complementary policies, yes.

Senator RIEGLE. Now I know you feel strongly about that. You've said so and that's been your pattern of action. We've had two discount rate cuts this year that were coordinated but the most recent one was not, and that really sticks out to me. I want to understand why the Fed, given the need for that kind of international coordination would have gone ahead with the last discount rate cut without our allies coming along with us.

Mr. VOLCKER. Let me make a general point first of all. I think the kind of broad coordination or complementary action that I'm talking about doesn't require close coordination or precise timing of every discount rate or monetary policy change. I think the issue is broader than that.

But we obviously arrived at the judgment, with this last discount rate change, that, given conditions in the economy and indeed given conditions in the exchange markets, a cut of one-half percent was appropriate and not likely to be unduly disturbing internationally in the context of events at that particular time. That was a judgment reached on the basis, in part, that while the dollar has been generally declining this year, it's been declining at a slower rate of speed, and in the last few months by and large has not been declining in the same one-way direction that it was earlier.

Senator **Riegle**. Did we ask the Germans and the Japanese to come along with us?

Mr. **Volcker**. Well, they were aware of our intentions anyway.

Senator **Riegle**. Well, I'm sure they might have been, but I'm asking a more direct question than that. I want to understand whether we're running into a difference of opinion internationally.

In other words, did we urge them to match that cut or to move at the same time or not?

ROOM FOR SEPARATE JUDGMENTS

Mr. **Volcker**. Well, I don't think I want to go into great detail. There are different judgments on these things. As I say, I don't think we should expect that they will move precisely the same day or the next day every time we move, or vice versa. But they reached a judgment clearly that whether or not we moved they didn't want to move this time.

Senator **Riegle**. Well, let me ask then this question. Does that mean that we still have the flexibility to maybe move again without them? Could we take another discount rate step if they are not willing to do so?

Mr. **Volcker**. Sure. I think that's implicit in everything I've said. We did it this time. It depends upon the setting. I don't think we're frozen into making every move precisely when others are ready nor are they frozen into making moves precisely when we think it's appropriate.

Senator **Riegle**. Well, if we can continue to make discount rate cuts now and not coordinate them—and I'm reading between the lines that we had given them signals that we hoped that they might come along with us—that leaves the impression that we in effect can move on an uncoordinated basis, that we can go ahead and lower the discount rate once, twice, maybe other times, without them, and the whole rest of your testimony argues against that.

Mr. **Volcker**. Well, I think I would make a distinction. Certainly much of my testimony argues and emphasizes that policy and developments need to be broadly complementary. There's no doubt about that.

But what's important, for instance, is that we get a fair amount of growth abroad in their own interest and the interest of the rest of the world. That may or may not require easier monetary policies. They have the question of fiscal policy. Growth may develop without further policy actions.

What's important is that the growth be there, and that is a question different from a much more technical and limited question as to how or whether or in what circumstances it's important, in a very narrow sense, to coordinate a particular discount rate or other changes. Sometimes that's very important in my mind. Other times it may not be.

Senator RIEGLE. Well, I want to get to the growth issue because I agree with you that that's critical and I think we need to discuss that at some additional length. What I'm concerned about now is that if we are so dependent on foreign capital to finance these huge budget deficits and trade deficits that we have, if we continue to make unilateral drops in the discount rate and bring down our own interest rates, and the other countries don't follow, what guarantee is there that we can continue to attract all this foreign capital that we're hooked on?

Mr. VOLCKER. Clearly, that is one of the risks that one has to take into account. The risk of excessive reaction in the exchange markets. The risk of—which is the same thing—losing the willingness to invest as eagerly in the United States. And that is why some coordination of these moves at some times is very important.

Senator RIEGLE. Well, I gather, though, that that's not a great concern of yours at the moment, that we may be reaching the point where——

Mr. VOLCKER. It is a continuing concern. The degree of concern waxes and wanes depending upon other circumstances.

Senator RIEGLE. Well, I guess that's what I'm getting at. I'd like to get a sense for the level of your concern in that area and I just have to tell you that my own concern is high and it relates precisely to the growth issue. Most of the economists today feel that the Western growth rate has to be about 3 percent if we're going to maintain stability and not have the Third World countries slip into a deeper adverse situation. I gather you agree with that.

Mr. VOLCKER. As a broad judgment, yes.

Senator RIEGLE. If we look at the picture currently, you mentioned that there is some pickup in Germany in the second quarter. You did not say anything about Japan. I assume that we're not seeing the same thing in Japan.

IMPROVEMENT IN GERMAN ECONOMY

Mr. VOLCKER. I do not see it to the same degree certainly. I'm not right on top of it, but I think the signs are rather clear in Germany. I don't see them so clearly elsewhere.

Senator RIEGLE. So the German pickup in the second quarter is something of an improvement, but do you see it on a broader base in the Western economies or not?

Mr. VOLCKER. I would point out, too, in looking at that improvement in Germany in the second quarter, that they had a decline. We're talking about a 1.1-percent increase at an annual rate in the gross national product in the United States, according to a preliminary estimate right now. Germany had a decline of 6.5 percent in gross national product in the first quarter, following a decline in the fourth quarter of last year.

Senator RIEGLE. That's right. But I'm saying——

Mr. VOLCKER. So they are getting a rebound from that decline quite clearly.

Senator RIEGLE. I guess what I'm concerned about here, is that we're in a very ticklish situation in the sense that we don't have a lot of maneuvering room left unilaterally. It seems to me if we're going to lower the discount rate much more, we're going to have to have a coordinated response from that. Now do you disagree with that?

Mr. VOLCKER. We haven't got a lot of maneuvering room, in a broader sense and sometimes in the narrower sense, on the discount rate. But that depends upon particular circumstances at the time.

Senator RIEGLE. I want to draw attention also to one other change in your testimony that was submitted yesterday versus the version today. In your text yesterday on page 4 on this very subject, you start with a sentence that says, "A major faultline runs through the economies of the industrialized world" and then you go on to discuss this problem in terms of how we work out these imbalances.

I noticed that you chose not to go with that language today and it seems to be softened. It seems to me we do have a major faultline running through here in terms of some structural disequilibrium we're going to have to manage our way out of. Isn't that really what you're saying?

Mr. VOLCKER. That is what I am trying to say. We have a structural disequilibrium and we have to work our way out of it. I decided that word was overly cute when I looked at it and might be taken out of context. It did not really convey what I wanted to convey, that this is something that we can repair. It didn't pass the wife test.

WITHDRAWAL OF INTERNATIONAL LENDERS

Senator RIEGLE. Can international lenders withdraw their money as a practical matter? Some people say that even if the foreigners who are loaning all this capital wanted to get out they really have no place to go. I don't tend to buy that thinking.

Mr. VOLCKER. Well, there is a logic to that thinking in the sense that for the United States as a whole, we are going to import capital because we must depend upon the current account deficit. You've got to pay for it.

Senator RIEGLE. Right.

Mr. VOLCKER. And the only way we can avoid importing capital is to reduce the current account deficit.

Senator RIEGLE. Right.

Mr. VOLCKER. But the terms and conditions upon which you borrow that money can change. If people are trying to get out—let's say at current interest rates and exchange rates—what would happen is that interest rates would go up and the exchange rate would go down. And that may not be what the doctor ordered in terms of a healthy U.S. economy. It is, in that sense, that we are in jeopardy.

Senator RIEGLE. Yes, but I'm saying from their vantage point, are they able to withdraw and put their money elsewhere? If foreigners want to——

Mr. VOLCKER. Only individuals are. Individual investors are always free to do that. On balance, if they do it—if somebody does it—we've got to replace that with somebody else's money and that is where the issue arises of what do you have to pay to do it.

Senator RIEGLE. Exactly. And that's what could produce higher interest rates.

Mr. VOLCKER. That is what could produce higher interest rates. And, on balance, they can't get out. Parts of that whole sum can get out, but then it would have to be replaced by other parts and the question is at what interest rate and what exchange rate would that happen?

Senator RIEGLE. My time is up.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much.

Chairman Volcker, first I noted that you did something that I, in my recollection, hadn't seen you do for quite a while and that is you delivered your entire 34-page statement. Obviously, you attach a lot of weight to what you have told us today and I do, too. I think it's a very comprehensive statement, probably as good as or maybe even better than any you've ever given and you maintain a very high standard.

GNP RATE

On page 26 of your testimony you make the following statement in part,

> We want to ensure maintenance of the remarkable progress toward stability as the economy grows more strongly and as a large amount of resources are shifted back to manufacturing industries as our trade imbalance improves.

So in your estimation, you're saying things should get better.

Then you go on to say,

> In looking toward growth in the 3- to 3.5-percent range next year, considerable emphasis was placed by Committee members on the potential contribution to that growth of a stronger trade balance.

Senator D'Amato explored with you to a certain extent what might or might not happen there; however, I've got a different question for you.

Would you consider growth, if it didn't come in at 3 to 3.5 percent, but averaged approximately 2.5 percent—which is, in fact, what it has averaged for the first half of this year—would you consider that strong growth?

Mr. VOLCKER. I would not consider 2.5 percent strong growth, no.

Senator HEINZ. Mr. Chairman, I would agree with you.

Now you have expressed concern several times in recent months about the possible negative effect on the value of the dollar if there was unilateral U.S. action taken by the United States. I assume you're referring to unilateral cuts in the discount rate. You have also said this may trigger a free fall that if we cut the discount rate and interest rates too precipitously and that that would limit the U.S. ability to attract the capital necessary to finance our current account deficit.

Now obviously if a rapid devaluation of the dollar did, in fact, limit our ability to do that, that could be a problem. But in cutting the discount rate as you did a few weeks ago, the dollar has only marginally fallen. The price of gold has remained relatively stable. It went up a little bit in dollar denominated terms.

POSSIBLE LOWER INTEREST RATES

My question to you is: Doesn't the absence of panic or the absence of any instability in currency markets in the wake of your action—which was unilateral—indicate that those markets are capable of coping with U.S. policy changes, additional ones of that kind, and that further steps to lower high real interest rates can be undertaken if appropriate conditions exist in the U.S. economy?

Mr. VOLCKER. It all depends upon what the surrounding circumstances are. When that change was made, I didn't anticipate it would have a major effect upon the variables you mentioned. Although the dollar has gone down since then, it's gone down partly because of the weaker economic news itself, which is one consideration and an important consideration that affects exchange market behavior. So other factors are at work here. It all depends upon the surrounding circumstances.

Senator HEINZ. Well, my followup question is, don't you think that if you did cut the discount rate another half a point or a point and that was followed as it usually is by other cuts in interest rates in this country, that that would be a sign to the world that the United States is serious about addressing the weakness of 2.5-percent growth, that it would signal that we anticipated taking the necessary steps to have a stronger economy, and that view of the U.S. determination to have a stronger economy in fact, would cause our currency to strengthen or remain stable rather than to weaken? Isn't that a reasonable point of view?

Mr. VOLCKER. I think in some circumstances that could happen.

Senator HEINZ. In 1979 or 1980, the Fed quite properly applied the brakes to an inflationary situation and I don't criticize the Fed for doing what they did then. But I think the Fed does deserve some criticism for not fully appreciating the economic circumstances that we were in by the time we got to 1982. We were into a recession and the Fed maintained the discount rate, as I recollect, certainly above 10 percent until July 22, 1982. There were no cuts for the first 6 months and even halfway through the seventh month of 1982. The economy was really in very difficult shape. I think there is no doubt that the Fed misjudged the economic problems we had and, although obviously this wasn't your intent, as a result, we ended up with a recession that was longer and deeper than we should have had, needed to have, and which still has been exacting some costs on us.

Now my question to you is this: Isn't it possible that just as in 1982 the Fed didn't wake up to the problems early enough that we are repeating history; and that the Fed is taking too benign and optimistic a view, is seeing the possibility through rose-colored glasses when indeed there's very little assurance that those possibilities are going to be as rosy and optimistic as you think?

Mr. VOLCKER. I'm inclined to say anything is possible, Senator.

Senator HEINZ. Well, you can do better than that, Mr. Chairman.

Mr. VOLCKER. But I don't want to associate myself with your Monday morning quarterbacking of 1982.

Senator HEINZ. It's Wednesday.

Mr. VOLCKER. I'm not sure. Anytime the economy deviates from what you would like to see, it's always easy to say that if you had only done something differently at the time maybe it would have been better.

I don't know whether if we had eased policy all that much sooner in 1982 whether we would have had anything like the progress we have had toward dealing with inflation, anything like the strength of the recovery we had, anything like the base we now have for future growth.

Senator HEINZ. Chairman Volcker, I understand that. No one has a perfect model and can predict with certainty what's what. I'm trying to determine in my own mind and for the record whether there is a bias that the Fed has had for the last 5 or 6 years that might have a major impact upon us as we once again seem to have entered into a period of economic weakness.

FOMC REPORTS INDICATE A STRONGER SECOND HALF

Now let me come down to what I've really been leading up to with these questions. There have been some recent reports indicating that at the May 20 Federal Open Market Committee meeting the Fed actually leaned toward tightening rather than expanding credit. The reports say that part of its inclination to maintaining pressure on credit seemed to have stemmed from a staff forecast that a stronger economic expansion could be expected for the second half of this year without further prodding from the Fed and any cut in the discount rate. Now is that correct?

Mr. VOLCKER. I would have to modify your description of that meeting a little bit. We did not lean toward tightening. What we said is we might lean toward tightening depending upon developments during that period. That is an accurate statement. It wasn't much of a leaning, but it said we might. We never did.

Senator HEINZ. Did not the staff forecast a fairly healthy economy in the second half?

Mr. VOLCKER. As that report probably indicated the staff was projecting increased activity in the second half of the year, along with about 90 percent of the other economists.

Senator HEINZ. Chairman Volcker, that's what I'd like to focus on, not the press release, but the staff report, because you rely, as do many of us, on analytical work done by very competent staff. But if they are wrong, if they misjudge something, at least—and you're quite right, you can accuse me of Monday morning quarterbacking, but I'm not a member of the Federal Reserve Board and maybe I would and maybe I wouldn't have been guilty of what I have intimated the Fed may have been guilty of in 1982. But in any event, not to put too fine a point on that, the question is: Why did the staff think that we were going to have a healthy economy in the second half of 1986?

Mr. VOLCKER. Well, let me distinguish between rate of growth and a healthy economy in terms of the imbalances in the economy. I think the staff forecast was outlined in that report, as it often is, in very general terms. I don't think, in terms of direction, it differed much from the garden variety forecast prevalent at the time—that the trade balance was going to improve; that you were going to get sustained consumption in the light of the decline in oil prices, among other things; that interest rates were down, the stock market was up. Those factors entered into a judgment that the economy was more likely to grow more rapidly rather than more slowly in the second half of the year.

I might say, too, that the responsibility for those judgments lies with the committee, not with the staff, which presents one point of view.

Senator HEINZ. I understand that but I would hate to think that you would simply ignore the analytical work and the data presented by the staff. It clearly has a great influence on your decision-making process. I don't think you would deny that.

SITUATION IN MEXICO

Let me just ask you this concluding question. You spent several pages in your statement singling out and discussing the situation in Mexico and appropriately so. They are a massive debtor. Their economy is in desperate straits. And you said that with the restructuring that Mexico has agreed to, Mexico expects to grow in 1987 and 1988 and to permit or complement that growth, it's going to need new bank loans over and above what it already has.

Mr. VOLCKER. Correct.

Senator HEINZ. Now if the United States economy should weaken or, God forbid, go into a recession, what will happen to Mexico's ability to grow and, for that matter, to service their already backbreaking debt?

Mr. VOLCKER. It would be impaired. Certainly their ability to grow would be impaired. Extension of lower interest rates would cause something of an offset to the financing problem, but I have no doubt that the American economy in a recession would make life still more difficult for the Mexicans and for others.

Senator HEINZ. More difficult even than now?

Mr. VOLCKER. More difficult than now, assuming the price of oil remains at current levels. Of course, if the price of oil went up, the Mexican current position would look quite different.

Senator HEINZ. Well, Chairman Volcker, you've given very good answers to my questions and the purpose of this line of inquiry has been to illustrate, I hope, that first, there's room for fallibility in economic forecasts, that the consequences of fallibility as we learned in 1982 and as might be the case as you've just suggested in the case of Mexico could be, in concrete terms, unusually severe and world-shaking. I think perhaps among other things, it also underscores what you've called for today, which is for other countries to cooperate with us.

But I've got to tell you that if they don't cooperate with us, I regret to say I don't think you're going to have many options left. I think you're going to have to cut and I think you will cut the discount rate—and you don't have to agree or disagree with that. Knowing you, you're so cautious and you're so prudent, and whatever it is you say you'll fuzz it up. [Laughter]. But nonetheless, I think you're going to be forced to do that, with or without help from our trading partners. I also think that the concerns that have been expressed about the dollar going into a free fall are rather pro forma. Speaking for myself, I don't really think that that would happen, but you're an imminent economist or practitioner of economics and I'm not going to get into an argument with you about that, but I thank you for your testimony.

Mr. **VOLCKER**. Let me comment just briefly on your rather summary statement. I don't want you to have the impression that there is some answer to all these problems by reducing the discount rate or easing policy or tightening it, without that move being part of a particular environment in the world economy.

Our domestic demand, which is what presumably you affect most directly by monetary policy and discount rate changes, has been quite strong. That is not the weak area of the economy. Consumption has been doing quite well. Housing is having one of its best years on record. You could presumably pump up that part of the economy for a little while longer and a little more strongly.

But that does not deal with the underlying imbalance that sooner or later we will have to deal with. It could aggravate it. So it's just not a simple either/or question, that if this other thing doesn't work we've got another policy instrument. You've got an inadequate policy instrument.

Senator **HEINZ**. Well, I could agree with you except for one thing. And that is, that if the United States does further lower its interest rates, other countries will have to do the same and that will bring about the stimulation of their economies, whether it be Japan or West Germany.

So I really can't quite agree with the conclusion you've come to. It's good as far as it goes, but it doesn't go far enough.

Mr. **VOLCKER**. Well, that's certainly right. There is nothing inconsistent about reducing the discount rate and other actions being taken that help the other problems.

Senator **HEINZ**. It's a little bit like who goes first, Gaston or Wakanobe. Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Sasser.

Senator **SASSER**. Thank you, Mr. Chairman.

RELATIONSHIP OF BANK AND PRIME RATES

Mr. Chairman, since the beginning of March, the Fed has lowered the discount rate three times from 7.5 percent on March 7 to its current 6-percent level. Now without regard to the advisability of dropping interest rates much lower—and we won't get into the merits of that—is there technically a point at which the discount rate cut is not going to cause banks to respond by lowering their interest rates? Are we getting close to that point?

Mr. **VOLCKER**. Well, the bank prime rate tends to bear a rough relationship with short-term market rates. The discount rate also bears a relationship typically to short-term market rates although the relationship can vary. So normally you would expect some relationship between the two.

I think a lot of bank lending these days is done at unpublished rates more closely related to market rates and if the market rates go down, those rates go down. That is the pattern you see on business lending.

Now when you're talking about mortgages, they tend to move in roughly the same direction but that's a longer term instrument and has other influences.

When you're talking about consumer rates, they are very sticky, particularly some types of consumer credit like credit card rates which haven't moved very much at all.

Senator SASSER. They haven't varied much in the last 5 to 8 years.

Mr. VOLCKER. That is correct.

Senator SASSER. They're still operating as if we had 20-percent interest rates.

Mr. VOLCKER. Well, on credit cards, they tend to be close to 20 percent.

Senator SASSER. Well, at what point, Mr. Chairman, do you think a further cut in the discount rate would reach a point of diminishing return as far as forcing further cuts in interest rates charged by banks?

Mr. VOLCKER. Charges by banks would tend to follow short-term rates in the market which tend to get pretty well integrated with the discount rate.

If you're talking about longer term rates—corporate bond rates, mortgage rates, that kind of thing—there is no necessary correlation and the limiting point in that area would be the minute the market began thinking that the cuts were clearly inflationary. Then, you might get a counterproductive action in the long-term markets with rates going up instead of down.

Senator SASSER. Do you think we might be reaching a point of diminishing return with regard to cutting the discount rate? Some economists are saying that you won't get much of a kick from a further cut.

Mr. VOLCKER. Well, I think that's sometimes said, not just because of the technical reaction of bank rates. Some might say that even if bank rates went down you wouldn't get much stimulus to the economy. I'm repeating myself, but I think so much of the malaise—if I may use that word—in the industrial side of the economy is related to the trade position. And I don't think you're going to see a dramatic change in the economy without some prospects of improvement on the trade side.

Another big element in the recent picture has been the decline in oil prices and investment in that area. Production of investment goods in that area have been cut to shreds—very sharp cutbacks in the number of rigs at work, the pipes that they take, and the work that goes into the exploration and development side of the oil industry.

Now maybe a decline in interest rates to some degree moderates that, but compared to the force of the oil price dropping from $25 to $10, it obviously has a minor impact on that particular industry which has been quite an important factor in this sluggishness in business investment.

So you get those kinds of distortions in some areas of the economy which are not going to be very responsive to a decline in interest rates.

Senator SASSER. They're just not going to respond sometimes, I think, because of the underlying structural problems that we have in this economy that have not been dealt with.

LOWER GROWTH RATE IN MANY CATEGORIES

With regard to this much balleyhoo'd—this "remarkable"—I put "remarkable" in quotation marks—recovery that we've experienced over the past few years. But when you compare this recovery to recoveries from recessions over the past 25 years, what we find in this recovery is the lowest growth rate of real GNP of all four recoveries in that period, the lowest growth rate of industrial production, the lowest growth rate of real after-tax income, the lowest growth rate of productivity, and the second lowest growth rate of employment.

Now superimposed on that, Mr. Chairman, we've been hearing some very disturbing reports about the state of this so-called economic recovery. People are beginning to wonder if this recovery is more public relations in some areas than it is reality.

In the first 6 months of this year, for example, the industrial production index dropped by 2.1 percent. That wiped out more than 80 percent of the production gains of 1985. And as of June of this year, we had more than 22 percent of our industrial capacity standing idle, more than at any time in the last 2½ years, as I'm sure you know.

Now we are seeing at the same time banks failing at a rate faster than last year when we set a record of 120 banks failing, capped by the failure a couple weeks ago of the First National Bank and Trust of Oklahoma City—which I understand was the second largest bank failure in the history of the country.

Now, Mr. Chairman, I realize that the Fed can't do everything, and perhaps I'm coming reluctantly to the conclusion we expect too much out of the Fed. But are we in the middle of a sustained economic stagnation as opposed to a much balleyhoo'd recovery? Which is it?

Mr. VOLCKER. First of all, let me just reserve the right to go back and look at some of those figures on that list that you reeled off because I am surprised at some of them. I am not surprised about industrial production. As we have emphasized collectively again and again this morning, industrial production has not been doing well over the past 2 years or so.

I might also mention that one of those figures explains the real income question that you touched upon and that Senator Heinz touched upon earlier. Productivity has not been doing brilliantly, to say the least. Overall productivity has been rather restrained for almost 10 years and that is the key to rising real income. You're not going to get average real income rising very fast if you don't have rising productivity.

Senator SASSER. Let me interrupt you there and just ask you this, Mr. Chairman. Did the recession of 1982, which was the deepest recession we've had since the Great Depression years of the 1930's, did that shake out any of our problems of productivity or are those productivity problems as pronounced as they were prior to the recession?

Mr. VOLCKER. Well, Senator, there's a certain mystery here to me—and I think to many other people—because you do get continuing reports that manufacturing productivity—if you talk to businessmen—is improving rapidly. They've done a lot of things to improve productivity and actually you see some evidence of that in the manufacturing sector of the economy.

It is really the rest of the economy—that broad and growing service area—where the productivity is so poor.

Now having said that, you have real statistical problems in measuring it when you get out in the service area. In these last revisions of GNP figures, the growth rate was raised largely because more services, so to speak, and output were found, and that, I presume, is going to make the productivity figures look a little better.

But in manufacturing you see some signs, and you would see more signs if you hadn't had this leveling that we both have been talking about. In the rest of the economy, no.

MERRILL LYNCH FORECAST OF ECONOMY

Senator **Sasser**. Well, last week, Merrill Lynch's chief economist, from Don Regan's old firm, predicted that there would be little or no growth in the second half of this year, much less any acceleration from the slow pace of the first 6 months of this year. This economist said business spending on new plant and equipment is likely to be weak over next year and the hoped-for lift to U.S. manufacturing from the dollar's decline in foreign markets remains way off.

I would ask you, Mr. Chairman, if you disagree with this economic forecaster and others who predict that there's not going to be any growth for the rest of this year and, if you do disagree, principally why?

Mr. **Volcker**. That does not seem to me a likely outlook for the various reasons that have been touched upon already. I was looking at my briefing book last night and I saw a Merrill Lynch forecast that must be a little out of date. It was 2 weeks old. It didn't show that. The papers said they've made a big revision in their forecast, which is perhaps a commentary on the volatility of these forecasts and one's inability to put too much weight on any forecast, including our own staff's forecast.

Senator **Sasser**. Mr. Chairman, I had an old law school professor who said one time the reason the dinosaur is extinct is that it couldn't turn around fast enough. That's not going to happen to Merrill Lynch's economist, apparently.

Mr. **Volcker**. That may be so. But this all comes back, I think, to the basic point I'm trying to make this morning—that these questions about the outlook are really inextricably tied up in this question of the trade picture. And once you begin looking at trade, it's tied up with what's happening in the rest of the world. So you really not only have to forecast the United States as best you can, but also you have to have some sense of what the prospects are in the rest of the world. And that's a new kind of world for us to be living in.

Senator **Sasser**. My time is up but I will just end with this statement. One of my principal concerns is that our economy may be coming noncompetitive in a world economy, and if we're depending on world trade to pull us out, it may be a long wait.

Mr. **Volcker**. Well, let me just respond to that comment, too. I think certainly with the change in the exchange rates that we've had we're a lot more competitive against our major industrial country competitors, but you also see some longer term trends that bear out your concerns. I don't think you can always repair that by changes in the exchange rate.

Senator SASSER. No.

Mr. VOLCKER. I think we have had some problems in the area of productivity. But I think that can change and it must change. When you look ahead in this economy for the next 5, 6, 7 years, it seems to me you must arrive at the unambiguous conclusion that our manufacturing industries are going to have to do a lot better relative to what they have been doing because that's the only way we can get the trade balance in to better shape. The only other assumption you can make is that it's not going to get in better shape and I just simply do not think that is possible over that kind of timeframe. What's at issue is how it gets in to better shape. Does it get into better shape in the context of a growing economy or do you have a much more difficult time of unsatisfactory adjustment effort? But it's going to have to get better sometime. It's got to start moving in that direction and that means we have to have a much more competitive—one way or another--manufacturing industry.

Senator SASSER. Thank you.

The CHAIRMAN. Senator Gorton.

BUDGET DEFICIT GOALS

Senator GORTON. Mr. Volcker, how important is it to both the short- and long-range future of our economy that Congress meet the Gramm-Rudman budget deficit goals for 1987 either at the $144 billion figure or within $10 billion of that figure?

Mr. VOLCKER. Well, I think it has been and remains crucially important that you make very substantial progress in that direction. I don't think that depends upon reaching any particular figure. I would emphasize substantial progress. You have a political target to be met and you have to have a certain amount of discipline, but I'm not good enough to answer your question within $10 billion. I do think substantial progress over time is going to be necessary as part of correcting this trade situation we have.

Senator GORTON. What would be the likely consequences of an abject failure to meet those goals or to make strong progress toward them?

Mr. VOLCKER. Well, I think the good news would be—and nobody can project this—that you go on for another year or so more or less the way we have been going on, with a trade balance not getting better, maybe getting worse, but the rest of the economy doing pretty well. The bad news would be when you run out of steam on that approach and part of the threat is not just a protectionist reaction to the trade imbalance, but economically there's a loss of confidence in the prospects in the United States. The capital doesn't flow in from abroad so easily, and you've still got to finance that same budget deficit. You have a mess.

Senator GORTON. Let's assume that we meet or come very close to meeting those deficit reduction goals. We will then have in place a fiscal policy aimed at reducing the deficit decisively. And let's assume for the time being no additional substantial stimulus from monetary policy.

Under those two sets of circumstances, what factors will cause growth in 1987 to be any larger than it is so far in 1986?

Mr. VOLCKER. Without improvement in the trade balance?

Senator GORTON. Pardon?

Mr. VOLCKER. You're assuming no improvement in the trade balance?

Senator GORTON. No, I'm not making any such assumption. I'm allowing you to state if we have a deficit reduction fiscal policy and no additional stimulus from monetary policy, why and under what circumstances will the economy go?

Mr. VOLCKER. Under those circumstances, I would think you've got a big force in there moving toward lower interest rates. But your major improvement—again, an improvement that is consistent with the direction we have to go over time—would be on the trade side which would feed back into business investment. But I think the important stimulating factor would be on the trade side feeding back into business investment and therefore into manufacturing activity generally.

Senator GORTON. Is it your view that at this point we have not yet seen much, if any, of the impact from previous discount rate reductions and the rather dramatic drop in the value of the dollar as respects our international trade deficit?

EFFECTS OF INTEREST RATE REDUCTIONS

Mr. VOLCKER. Well, I think you have seen the effects of the substantial reductions in interest rates that we've had for about a year now, whether or not they are directly tied to changes in the discount rate. I think housing is doing well and parts of consumption are doing well. So I think you see those effects rather directly. I don't think you've necessarily seen all those effects.

On the trade side, you have not seen it in a pronounced turnaround in trade flows or even an absolute leveling off so far. I think you can see evidence of an improved competitive position and at least maybe scattered evidence of the order situation changing a bit. There are fewer orders for exporters apparently in Japan and Germany. There are other factors at work but that's one factor. There are reports of more orders by some of our industries that are heavy in the international area, but it's still in the beginning turn around stage in orders and expectations than in actual trade flows. You do not see it in actual trade flows.

Senator GORTON. Is it your view that the decline in the dollar as against the yen and the mark has—I can't say it's run its course—but a further substantial decline of the value of the dollar against the yen or the mark would be likely to have more adverse than positive consequences?

Mr. VOLCKER. Again, it depends. Given the circumstances that exist, I think the most important and constructive way that we can get an improvement in our trade balance—given the substantial depreciation we've already had—is through expanding markets abroad.

Relying entirely upon exchange rate changes certainly does help our competitive position and in concept will improve the trade balance and our economy. If nothing else is done, however, it may weaken the foreign economies. So again, you don't have the markets for your goods. It depends upon whether they have other things going on that help to push their economies forward and that's what's been in some question.

In some European countries and in Japan, as they've faced a tougher competitive position internationally, there has not been a thrust of internal growth to replace it. They either have a very sluggish situation or no growth at all. If we're going to improve our trade balance and they reduce theirs, they've got to have more internal growth. It's just almost arithmetic. And if that's not there, there will be a sluggish picture, one that's not very good for our exports.

Senator GORTON. On another but related subject, a great deal of your written and oral testimony relates to the international debt situation. I think it's appropriate to describe your views on some nonoil producing countries as relatively positive. Declines in interest rates and growth in productivity and the like has been very helpful to Brazil.

Mr. VOLCKER. Precisely. I think there's more progress in that area than is generally realized.

Senator GORTON. But, of course, that's not true with respect to oil-producing countries, especially the Latin American oil-producing countries.

RESTRUCTURING DEBT OF OIL-PRODUCING COUNTRIES

Mr. VOLCKER. Even some of the oil-producing countries—take a small one like Ecuador—a great deal has been done to restructure the economy and to open it up and improve its competitivenss. They were in the midst of doing that in a rather aggressive way and then were hit by the oil situation proportionately as much as Mexico. The numbers, of course are smaller for Ecuador.

Senator GORTON. Focusing on Mexico, is it your view that without a real increase in oil prices over the period of the next 2 or 3 years that its debt is in any way manageable or sustainable without a cut in interest rates or some kind of forgiveness of principal.

Mr. VOLCKER. Well, I think it could be manageable even under those circumstances, but it obviously would be a lot easier should the oil price go up some. I wouldn't particularly forecast this, but if the oil price in real terms stayed down, the Mexican economy is going to have to reorient itself more quickly and more heavily around nonoil business, and that requires a lot of structural change consistent with the directions they've announced in the last few days. They want to go in that direction anyway. But certainly there is an additional burden upon them. Every time the oil price goes down by $1, it's another $500 million to Mexico on the minus side. When it goes up, it's on the plus side.

Senator GORTON. If you were a private banker—I'll give you two examples—either without much investment in Mexico or with a large amount of investment in Mexico, would you be willing to follow up with more now as a result of this IMF agreement?

Mr. **Volcker**. I think that obviously has to depend upon what you think the prospects are, and that gets back into some evaluation of their program. But if I had a large exposure to Mexico, knew that they were very hard hit by the oil situation and trying to cope with it, and I had a large stake in preserving the stability of what I've got, I would look at what is necessary to help Mexico do what will retain and improve its creditworthiness over time. And that is the issue.

Senator **Gorton**. Thank you, Chairman Volcker.

The **Chairman**. Senator Sarbanes.

Senator **Sarbanes**. Mr. Chairman, I join with my colleagues in welcoming you.

I want to diverge for just a moment. I've been chairing some hearings in the Joint Economic Committee on our statistical base, our information base, and in the course of those hearings as they've progressed I think there's a growing concern that lack of accurate information may in fact be becoming an increasing impediment to our economic growth and to important policymaking, both public and private.

LACK OF ADEQUATE DATA FROM AGENCIES

I'm prompted to ask the question by your reference on the GNP growth figure and the point you made that while the second quarter figures were anemic the first quarter figures have been revised upward. That reflected that the trade figures in particular are inadequate and, of course, that's quite true. What we have is actually the Customs Bureau still doing it by hand. They don't even have it computerized and the Commerce Department now in effect appends a consumer warning on each monthly package of trade numbers that it issues by talking about the carryover rate. In effect, they say we can't really vouch for anything that's in here.

You also have this problem on accounting accurately for the service sector of the economy. We've not updated those statistics.

How much of a concern do you have about the deterioration of our ability to collect accurate statistics for the purpose of economic decisionmaking?

Mr. **Volcker**. Well, I have no great expertise in statistical collection, but I share the view that you infer that the amount of money and effort spent on dealing with these statistics is not up to the job currently, given the attention that we give to these figures.

But I also have the feeling—take that service side of the economy—that there's just inherently very difficult conceptual problems that suggest that nobody is going to have perfect figures. Take the housing price figures where the method of collection changed. Both the old method and the new method had their own kind of purely statistical imperfections of some size. Depending on the method used you get a widely different result over the past 3 or 4 years. I think if the old method were still being used, the consumer price index would have shown a decline in housing costs over this period. Using the current method, housing is one of the fastest rising elements in the Consumer Price Index.

I would conclude from that that some of these problems are pretty insoluble. We are all tempted to put too much weight on these figures. They all should be taken pretty much, in varying degrees, with that warning that you noted for the Customs figures—too much reliance on these figures may be dangerous to your health.

I also think that some figures are inherently more reliable than others and among the more reliable are some of the employment figures. It's interesting that they have shown a consistently stronger economic picture over the last couple of years than the GNP figures, and now the GNP figures have been revised upwards. Revisions for last year and the first quarter of this year put the GNP a little more in line with its historical relationship with the employment figures.

So we have those problems which I don't think we can solve completely. You can deal with them to a degree with more money and more effort, but I think there are some problems that just lead to a certain caution in using any of these figures.

The trade figures are a classic case in point. They jump way up and down month by month and then you find out that the figures may not even refer to the month that they are reported for.

Senator **SARBANES**. Recognizing that you have to be careful in your use of them, at least I would submit that the quality of our statistical data—the quality of it—is the vital factor in making sound judgments possible. Good statistics will not guarantee good policies but they are part of a framework of decisionmaking which makes good policies more likely.

Mr. **VOLCKER**. I could hardly disagree with that and I think my gut feeling is there may have been some slippage. The effort put into this has not kept up with the increasing complexity of the economy.

Senator **SARBANES**. I might note that the Japanese today have a national statistics law and they have a month-long national celebration in honor of statistics and the theme of that month-long celebration last year was "Statistics are the Beacon for a Happy Life."

Mr. **VOLCKER**. Well, we could have a national statistics day.

COMPLEMENTARY ECONOMIC POLICIES

Senator **SARBANES**. Let me turn to your statement. First of all, I want to address this point on the coordination of economic policy among the industrial countries. On page 11 you say, "Those underlying imbalances can only be dealt with by complementary economic policies."

What are the factors, in your judgment, that have prevented or precluded the development of complementary economic policies? Why aren't the countries able to get together?

Mr. **VOLCKER**. Well, one of those areas where I think we need complementary policies deals with our own budget deficit, and you are one of the world's leading experts on the difficulty of dealing with our internal budgetary deficit.

I think clearly other countries have similar difficulties. We used to think that fiscal policy could be conducted with some flexibility. I think any hopes on that have been reduced over the years. When one looks at this in an international context, one of the things you run into is that there are very firm and fixed long-run fiscal objectives—budgetary objectives I suppose I should call them rather than fiscal objectives—in some of these countries. They don't want to deviate from those very fixed objectives in terms of reducing—or eliminating—what were once very high budget deficits.

So that's a clear problem nationally and internationally.

Senator SARBANES. Do you think the effort on the part of the major industrial countries to coordinate their policies has diminished? There used to be a time when the meetings of the OECD were regarded as extremely important.

Major efforts were made to develop a coordinated economic approach. Now my perception is that Secretary Baker has tried to revive that, at least to some extent. Would you agree with that?

Mr. VOLCKER. Well, I've been watching this process for many years now and it's never been easy. It's always fallen far short of what one considers the ideal. I don't really think it is all that much different in recent years than it was earlier. Certainly Secretary Baker has made some particular procedural proposals which are aimed at creating an environment and a kind of discipline that would produce more substantive results. The first stage is a procedural one and that's difficult enough, but he's certainly working on that problem.

Senator SARBANES. Would you say the Treasury under his leadership is showing a greater sensitivity and concern for this coordination than has previously been the case before he took over?

Mr. VOLCKER. Well, I'm not going to make comparisons but he is certainly concerned with this problem and I think he's demonstrated that in the initiatives he's taken.

Senator SARBANES. Now on the Baker plan for the international debt situation which you discuss at some length in your statement, do you think that reasonably assured financing by international institutions has been given sufficient weight in the Baker approach?

Mr. VOLCKER. I think it's been given sufficient weight in the approach. Whether it's been given sufficient weight in practice is another question.

Essentially, since he made that speech in Seoul last year—which was kind of a codification of what had developed case by case, with some further emphasis on growth—we have not had a big test case, so to speak. So this is really the first that we have had. There has been progress in some directions on a more piecemeal basis or with much smaller countries, but the amounts involved are so much smaller it hasn't been a real test. So we are going to see whether we have adequate progress in that direction in the Mexican case.

Senator SARBANES. Wouldn't it be a positive path to follow to try to shift some of the Third World debt or the ratios at least of the Third World debt from the private sector, the private banks, to the international institutions?

Mr. VOLCKER. Actually shift the debt, the outstanding debt or new debt?

Senator SARBANES. Well, shift the ratio which of course could be done by shifting the new debt.

Mr. VOLCKER. Well, as part of this process, I think yes.

Senator **Sarbanes**. Because you make the point that the private exposure is diminishing in a number of these countries and if that happens where are the countries going to find the growth?

Mr. **Volcker**. As a matter of emphasis, I think that is shifting and should shift through relative amounts of new debt. I'm not sure the banks should just walk away from this problem. I think they should be involved. But as a matter of emphasis, yes, I agree with that.

DEALING WITH DETERIORATING FRAMEWORK

Senator **Sarbanes**. And my final question is—and it follows along the line of questioning of Senator Sasser—earlier this week the former Chairman of the Council of Economic Advisers, Alan Greenspan, was quoted in the Washington Post as saying,

> We have had all the elements which now should be affecting the American economy in a positive way. The fact that they are not raises some very serious questions about whether we are looking at the fundamental forces that are driving the economy. It's too early to say we're on the edge of a recession but there is no question that the underlying framework is deteriorating.

I'd appreciate your comments on that Greenspan quote.

Mr. **Volcker**. All I can do is repeat, I suppose the theme of much of what I am saying this morning—that international imbalances are large and they have been growing. And in that sense the framework has been deteriorating. It should be of first priority in terms of our own development of policies here and abroad to deal with that, in his words, "deteriorating framework."

Senator **Sarbanes**. Thank you, Mr. Chairman.

The **Chairman**. Mr. Chairman, there are some additional questions that some of the members of the committee wish to ask you in writing. Senator Proxmire and possibly Senator Riegle have additional questions. I do have another meeting that I have to go to, so I leave you to the tender mercies of Senator Proxmire.

Senator **Proxmire**. Thank you very much, Mr. Chairman.

Chairman Volcker, I have just a few questions. First, I'd like to say I couldn't agree with you more on your concern about our statistical figures that you and Senator Sarbanes brought out so well.

EMPLOYMENT FIGURES

You referred to our employment figures as being among the more reliable. We're very proud of our employment figures and people say they're the best in the world and the most exhaustive. On the other hand, just last week there was a detailed article in the New York Times going into considerable lengths in documenting the weaknesses of our employment figures.

Mr. **Volcker**. Of the employment figures?

Senator **Proxmire**. Yes, indeed, especially the household survey. The establishment survey is much more reliable.

Mr. **Volcker**. I was thinking particularly of the establishment survey. They've got some deficiencies also. I'm no expert in these figures, but my comment was really directed toward the establishment figures.

Senator **Proxmire**. Of course, one of the problems is that we count anybody employed who has worked at least an hour in the preceding week so that people who are working part time for economic reasons are considered employed.

Mr. VOLCKER. But you also have hours figures, and some of that shows up in the hours figures.

Senator PROXMIRE. Well, to some extent they do. And then we don't count discouraged workers. If somebody has looked for a job and looked for a job and can't find one and stops looking, they're not considered to be unemployed. In fact, it was estimated by the experts they interviewed that if our unemployment figures were accurately kept, they would be about twice as high as shown, as much as 14 percent instead of 7 percent.

Mr. VOLCKER. On the other hand, unemployment in those terms is a state of mind. We do have more people employed relative to the working age population than ever before.

Senator PROXMIRE. No question about it, and that's an important figure. It's something over 60 percent now. It's higher than it's ever been.

I'd like to ask you about the banking bill introduced by the chairman of this committee, Senator Garn, S. 2592. As you know, it makes a number of major changes in our banking laws. Although the nonbank bank loophole would be closed, S. 2592 also makes it far easier for diversified firms to buy and operate savings and loan associations as a unitary thrift holding company.

Now I'm concerned that the character of the thrift industry could be profoundly changed over the years if we allowed that to happen.

Moreover, it will become increasingly more difficult to supervise thrifts when they come under diversified corporate ownership.

Is that the direction you think we should be going or not?

Mr. VOLCKER. You're commenting on the draft bill that I understand is in the process of revision. But I do not think the approach that earlier bill took toward the thrift industry—or the possibility of banks buying thrifts and through that avenue acquiring what powers might be provided by the Home Loan Bank Board—was satisfactory. With the liberalization of the powers of thrifts to provide demand deposits and all the rest, it purports to close the nonbank bank loophole but opens up another loophole that could be larger and produce a real mixture of commerce and banking.

Senator PROXMIRE. Well, I share that view and I'm very grateful to you for stating it so clearly and explicitly.

Now because of the lateness of the session, it's been suggested the only way to get a banking bill through the Congress is to drop all controversial items and deal only with essential matters. Some contend that only two items are really essential—the FSLIC recapitalization and the regulators' bill on the interstate sale of failing banks.

CLOSING NONBANK BANK LOOPHOLE

To that list, I'd add a third—the closing of the nonbank bank loophole along the lines of the bill passed by the Senate in 1984.

What are your views on this? How essential is it that Congress close the nonbank bank loophole this year?

Mr. **Volcker**. Well, I think it's quite essential that the Congress really resolve this issue. With each year that it doesn't resolve the issue, the market obviously does move and the difficulties of pressing a congressional view on the direction the banking system should take gets worse. I think that's illustrated by the fact that Senator Garn has made very firm statements in the past about grandfather dates and that kind of thing but they seem to be up in the air again.

So I think it's important that we act in this area. I don't see any inconsistency between acting and going at least a bit beyond what you describe. This issue of so-called powers has been thrashed out again and again and I think it's time to act.

Senator **Proxmire**. Well, do you agree that that kind of a stripped-down bill may be the most practical in view of the fact that we have only a few days left in this Congress?

Mr. **Volcker**. Well, that's a matter of legislative judgment. I think those items are essential items. Whether it's best to strip them down or not is a matter of legislative judgment but I think they are very important.

PROBLEMS WITH THE THRIFTS

Senator **Proxmire**. Now my next question is, how sick is the thrift industry? We're getting conflicting opinions on the condition of thrifts and FSLIC. The Reagan administration has recommended that FSLIC borrow $10 to $15 billion to liquidate insolvent thrifts. However, a recent article in the Wall Street Journal argued the administration's plan was woefully inadequate and that at least twice as much money would be needed. At the same time, the U.S. league has contended that the problem can be solved without any borrowing.

What are your views on the problem of the FSLIC and the adequacy of the administration program?

Mr. **Volcker**. I have not looked at that in great detail. The thrift industry is currently made up of a great many extremes. A large number of thrifts that have stuck to their knitting and put good loans on the books are doing quite well now. With interest rates down, their margins have improved, even dramatically, and they are in quite healthy condition. Some of them had gravely weakened capital positions earlier, but in many cases those capital positions are being recovered.

On the other hand, there are a sizable number of thrifts that have increasing asset problems arising from less conventional areas of lending and activity. I think that has become an increasing problem and that's what puts the burden on FSLIC. The quicker some of those problems can be taken care of, the smaller the problems will be over a period of time.

It also highlights the supervisory problems that have existed in that industry. I think Mr. Gray, through enormous difficulties, has moved quite forceably in this direction, given the problems he has to cope with. But there has obviously been a lot of room needed for improvements. So I think that side is relevant as well.

But some enhancement of the resources of the FSLIC would enable them to take care of some of these problems more expeditiously.

Senator **PROXMIRE**. Is there any reason to believe that the administration's plan on thrifts is inadequate, the $10 to $15 billion?

Mr. **VOLCKER**. I have no analysis that would suggest that. Obviously it is an area of estimates here, but it does provide a large supplement and certainly provides what would appear to be a reasonable sum at present.

OWNERSHIP OF CONSUMER BANKS BY DIVERSIFIED CORPORATIONS

Senator **PROXMIRE**. I have one other question. Those who favor nonbank bank or a consumer bank concept argue there's nothing wrong with a bank being owned and operated by a diversified corporation as long as the bank is a separately organized subsidiary that is examined and supervised by the bank regulatory authorities.

Do you see any potential problem if we open up the opportunities for owning limited-service banks that only make consumer loans?

Mr. **VOLCKER**. Well, if they only make consumer loans it would be less of a problem. There's enormous possibilities for a tie-in even in consumer loans. You see it in the automobile companies where they choose to provide a competitive edge apparently through subsidized credit rather than through other pricing opportunities. And somebody who is able to do that—which is an effective marketing tool—has an advantage over other competitors. So there are problems in that area.

More generally, as you say, the concept was put forward that if these institutions were regulated and supervised like other banks—if they are insulated from their corporate parent it's OK. Maybe so. But I think the corporate parent would have limited interest in running these nonbank banks if they were really insulated from the rest of their business. Why are they interested in getting them in the first place?

Senator **PROXMIRE**. What about the ability of the regulators to effectively supervise the thrift if they can't regulate the corporation that owns it.

Mr. **VOLCKER**. Well, there are two ways of doing it. One is to supervise the parent, which is neither possible nor feasible. Nobody wants to extend banking supervision into that area. Or you could draw a very, very tight line around the banking subsidiary. And as I said, if you drew that tight a line, I don't think anybody would be much interested in buying them. They would then have to buy them as a bank, not because they fed into their commercial operations. You have examples of that historically in the thrift industry and I don't think there's anything particularly the matter with it, if you maintain that distinction. But if you maintain that distinction, as a practical matter it also involves the supervisors of the bank to make sure that tandem relationships don't develop between the bank and its parent.

Senator **PROXMIRE**. Senator Riegle.

Senator **RIEGLE**. Mr. Chairman, just as a follow-on to what Senator Proxmire was asking, the three items that you thought, along with Senator Proxmire, are key items in my view as well. They include getting a banking bill through this year that takes care of the emergency acquisition authorities which you and other regulators need, taking care of the FSLIC recapitalization, and doing something on the nonbank bank issue. Are there any other key items that have not been mentioned that you think have a sufficient degree of urgency that you would put them into the same category as those three?

Mr. VOLCKER. You have this whole contested area of what I will call powers. When you say nonbank bank, if you take the very restricted view of a nonbank bank I would say you have to take care of nonthrift thrifts, too. It's a parallel problem.

I think those cover a large part of the areas that require early attention. There are a lot of questions dealing with the insurance system that I think are very relevant but may be less ripe for decision. In fact, in my view, many of those are not ripe for decision.

Senator RIEGLE. You mean the Federal Deposit Insurance System?

Mr. VOLCKER. The Federal Deposit Insurance System, although I think there are very important questions that ought to be looked at. Changes are necessary there, but it's only a question of timing, not of relevance to the subject.

Senator RIEGLE. Economists are now divided on the economic outlook. Several members have mentioned forecasts by certain economists that are quite pessimistic.

Mr. VOLCKER. If I might go back to your earlier question in the area of more emergency areas, I know the FDIC has a strong interest and I think it makes good sense—this transitional bank idea in handling a failed or failing institution. So that might be another element.

POSSIBLE RECESSION

Senator RIEGLE. All right. I appreciate that elaboration.

As we've been discussing here this morning, economists generally are quite divided on the economic outlook. You can find people that are very pessimistic and some that are more optimistic and so forth.

Against that backdrop, we do have all these serious structural problems which I think you've laid out chapter and verse in your statement and I think they are very sobering and very worrisome.

And my question is this. As we try to formulate these policies and try to get the international cooperation and coordination and so forth, and as we go along here over the next few months, if despite our best efforts, for whatever the reasons—the oil price goes too low for economic reasons and stays there or other events—we begin to slide into a recession in this country and presumably more broadly, how serious from the point of view of timing, if we were to find ourselves moving into a recession over the next 6 or 12 months, does that come at a particularly worrisome time in terms of all these structural problems? Is it something we think we could pretty much just take a deep breath and deal with, or should we view that prospect if it were to start to loom as one that would cause us to say we'd better figure out how to avoid it?

Mr. **Volcker**. Well, it's obviously desirable to avoid it in any event and it would complicate our problems under any circumstances. But I would have to emphasize again that the seriousness of that situation would depend a great deal upon whether the rest of the world, at the same time, was moving ahead with some buoyancy, or whether there was also a threat of recession in the rest of the world. That would greatly aggravate the circumstances and the difficulties of dealing with it.

That is the thing you don't want. You don't want that coordination—you don't want a coordinated recession. That's for sure.

Senator **Riegle**. Well, that gets right to my point. If we started to see ourselves working our way into a recession that was worldwide and the other Western countries were involved in it as well as ourselves, what I'm really asking is if this backdrop of structural problems which have been piling up over a long period of time are now of such a magnitude and difficulty that this would pose some exceptional dangers for us.

Mr. **Volcker**.Yes, because that problem is aggravated by these underlying structural problems which is why I emphasize them and the need to deal with them. That is precisely the point.

Senator **Riegle**. Well, I conclude from that in listening to everything you've said today, every word, that we really need to coordinate these policies, take the tough medicine that we must take as a nation, and in conjunction with our allies work out a common plan and carry it out. If we don't—if we were to fail in that effort, either in taking our own steps or working with them to take the steps that they need to take, and we would go into a worldwide recession at this point, a particularly dangerous situation. It's something that ought to be avoided, I gather, pretty much at all costs.

Mr. **Volcker**. I think the premium on nonconstructive action is very high and I would just put a footnote on that. It doesn't necessarily mean a need for new action in all cases. In some countries abroad, we may be building up the momentum that's necessary, but that's a rather critical judgment to make.

Senator **Riegle**. The evidence by and large isn't there yet to tell us that.

Mr. **Volcker**. The evidence is mixed, I think, to put it neutrally.

Senator **Riegle**. Well, that may be more generous. Maybe it is mixed. When I look for the bright spots, I——

Mr. **Volcker**. It is mixed in a technical sense. Canada has a record quite similar to our own. Their domestic demand has been expanding quite rapidly but their trade surplus is very high. Their current account has been deteriorating. They haven't got the big deficit we have, but it's been deteriorating and they've had a pretty good rate of growth.

Italy currently, for instance, has had quite vigorous growth and a lot of domestic demand over the past year or so. Other countries, obviously there are a good many, where you can't make that statement.

Senator **Riegle**. Right. No one quite knows then, just to carry through this macroeconomic analysis, where we may be headed here, because of this divided opinion and these high risks that are there because of all the structural problems. If we actually carry out the Gramm-Rudman cuts which are more than just a political requirement—they are now the law of the land in terms of trying to hit this $144 billion deficit next year—we're going to come in this year somewhere over $220 billion in the deficit. That's the latest estimate from OMB, as you know. I think it could be maybe $225. Who knows? But it's going to be in that range.

REDUCTION OF $76 BILLION IN THE DEFICIT

If we manage to go from $220 this year down to $144 next year, it seems to me that is a very dramatic reduction in the deficit. To go down $76 billion at one time, which is what the law now mandates us to do, may be precisely what we've been struggling to do for a long period of time, but it may happen at a time where for some kind of cyclical reasons we may want a good part of that deficit reduction or we may not want that much simply because it may be too much contrary to the softness in the economy. Does that give you any particular concern?

Mr. VOLCKER. I think it's obvious—with the current estimated deficit going up and with growth of the economy somewhat slower even through the first quarter—that you would have a much bigger cut than was anticipated. This raises a question from a purely economic standpoint whether that bigger cut is feasible.

As I said earlier, I'm at least not good enough to tell you down to the last $10 billion where success in this effort rests. I would simply say, as I've said so many times before, that a very significant move in the direction of getting the deficit on a declining path is what's called for.

Senator RIEGLE. Is it likely to imagine, if we were to do that in what is a relatively short timeframe. You've got to go from a spending pattern that's giving you a $220 billion annual deficit within literally 1 month's time as you click into the new fiscal year. On the average you've got to a spending pattern that takes you down to $144 billion if you're going to get this reduction in deficit that Gramm-Rudman requires—if you take that much stimulus out of the economy. If you argue that Government overspending, if you will, nevertheless stimulates the economy, if you take that amount of stimulation out that abruptly, is it likely that anything else in equal amount could materialize to come in and fill that gap that you would see?

Mr. VOLCKER. I do think we have to take that stimulus—it's got pluses and minuses—out of the economy over a period of time if the trade balance is going to improve, but we can't be unrealistic about how fast that can take place. What's really important is a clear sense of direction on both of those fronts which are related and not just a sense of direction for some trivial amount, but a sense of direction that reflects some real quantities.

Senator RIEGLE. A significant change in direction.

Mr. VOLCKER. I don't know whether that's a good word or not. A substantial change.

Senator RIEGLE. Substantial or whatever. I mean, it's got to fundamentally change the trend line. You've got to sharply decline deficits rather than incline deficits.

Just a couple of other areas. In an article in today's Washington Post about the latest tentative agreement here between Mexico and the IMF on the new loan program, it says that commercial banks might be called upon to put up $5 or $6 billion in new money over the next 2 years. It went on to say that the banks are under pressure from Secretary Baker and from yourself to get involved in this in terms of coming up with the money, and that many were reluctant to do so because they felt that even they would reduce some of their exposure and they may still feel overexposed and not have much appetite for that additional lending.

FURTHER LOANS TO MEXICO BY BANKS

My question really is along these lines: Are we intending to put pressure on the major or even the smaller banks to put money into Mexico? Are they absolutely free not to do it if they wish? And also, I'm wondering if we're doing this as a matter of national policy? Clearly we are. Your whole statement about interdependence today I think really underscores that.

If we really need as a matter of national policy to extend additional credit to these countries, why shouldn't the Government, our Government, do it directly rather than force the banks either grudgingly—some maybe willingly and some by gunpoint—to have to come up with the money when they don't want to? Why run the risk of impairing the balance sheets of the banks when we've got so many in trouble anyway? If this is a matter of enormous national self-interest, why don't we just face that and do it directly?

Mr. **Volcker**. Well, we do do some.

Senator **Riegle**. I'm talking about the increment here, though, that apparently they're going to do.

Mr. **Volcker**. This whole program assumes—and this is not a change in policy—some significant lending by the CCC for the purchase of our agricultural crops to Mexico, perhaps the Paris Club agreement, and other lending by the U.S. Export-Import Bank as well as other countries' export financing agencies to provide some very significant assistance to Mexico in financing their exports. So there is some direct assistance by the U.S. Government and by other governments.

I think it's fair to say that those countries with great big surpluses now and a lot of capital to export, might want to look particularly carefully at that area.

Beyond that, all of us officially in the developed world, of course, ultimately provide the support for the World Bank and for the IMF. This larger role that the World Bank in particular is assuming is supported by the collectivity of governments in the industrialized world.

Finally, I don't think it's inappropriate that banks be asked by Mexico to participate as part of this program. They have the loans. They have a large stake. If the program is an effective one and they think it's adequate, they ought to take some risks and participate in the program, given the amount of risk they already have and their involvement in those countries and their eager lending in the past. There is a common responsibility there. I don't interpret that as putting pressure on those banks.

Senator **Riegle**. Are they free not to do it if they want to? I mean, they're not going to hear from you or from Baker?

Mr. VOLCKER. In the end, it's their decision. I think what tends to put the pressure on, to use that word, is that if banks are going to respond there is a strong sense of pressure or discipline to respond jointly, because there's obviously a problem if some banks are asked to lend disproportionately more in relation to their exposure than another bank. So there's a certain discipline that works through the system which is not unique. What's unique here is the scale. But it's not unique with the situation they face with troubled borrowers in an ordinary situation with a variety of creditors. You don't solve those problems unless the creditors hang together and take proportionate shares in whatever risks are involved. So you have that problem here in spades, with hundreds of banks involved all over the world, not just in the United States. That is the real pressure on this situation.

Senator RIEGLE. Just one final thing. I raised this at the outset. Your term runs for another 12 months. It ends in July of next year. Is it your intention to remain through the end of the term?

Mr. VOLCKER. Well, I left myself some flexibility on that score and I think I'll just leave it.

Senator RIEGLE. Well, everybody pays attention to what you say especially in this setting, and I think the world economic people are very much interested in that question and you may have to leave it that way for your own reasons. I just want to say again that I hope you will finish the term. In fact, I would hope the administration would think about asking you to stay beyond that, which you might or might not be willing to do. I think the continuity and the stability and the sense of confidence that we need to maintain here is a very high and critically important level, and I think is rising because of all the problems that we've been discussing this morning, I think to get through this problem it's going to take extraordinary skill, management, good judgment, and leadership—and that's in short supply.

So that's my thought on it.

Mr. VOLCKER. Well, I appreciate that confidence, Senator, and I'm still here.

Senator RIEGLE. Good.

Senator PROXMIRE. Well, I want to add to that. I think you should by all means accept another term and a term after that if at all possible. If Don Riegle is President of the United States, maybe you'll get that, but I think the prospects are not great, but anything is possible.

Mr. VOLCKER. Well, I have no greater ambitions.

Senator PROXMIRE. Regardless of that, I want to say that I've listened to a lot of witnesses in 30 years, that you're frank, you're direct, you don't duck, you don't dodge, you don't double-talk; you answer frankly, and yet you don't get in trouble. That I can't understand. I have yet to hear any Diamond Don remarks from you at all.

What I can't figure out, however, is how you can sit there smoking a cigar which undoubtedly is carcinogenic. You don't get cancer. You don't have heart disease and you seem to go on and on and thrive on it.

Mr. VOLCKER. I hope all those comments are justified.

Senator **Proxmire**. Maybe we should find out what brand you smoke.

Mr. **Volcker**. I just have faith that all those comments are justified. Sometimes I wonder, but I find these sessions useful in trying to clarify my own thinking and understanding what's on your mind and I appreciate your attention.

Senator **Proxmire**. Well, you certainly clarify our thinking. Thank you very, very much.

The committee will stand in recess.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Response to written questions of Chairman Garn, Senators D'Amato, Mattingly, Proxmire, Riegle, and Dixon follow:]

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN GARN FROM PAUL A. VOLCKER

Question: Nominal interest rates have declined since last fall.

For real interest rates to fall, however, nominal interest rates must fall faster than inflationary expectations.

While it is impossible to measure inflationary expectations directly, the sharp decline in commodity prices since last year together with low measured rates of inflation this year suggest that inflationary expectations may have declined even faster than interest rates since last year.

In spite of the decline in nominal interest rates since last fall, do you believe it possible that real interest rates may have actually risen and, if so, given the relatively weak economy thus far this year, shouldn't the Fed be pushing harder to lower interest rates?

Answer: Given the difficulties you note with respect to the measurement of inflation expectations, one cannot state with certainty what has happened to real interest rates. There is survey evidence, however, that indicates that expected rates of inflation have fallen less than nominal interest rates over the past year; moreover, the behavior of exchange rates, of stock prices, and such interest-sensitive areas of spending as housing is consistent with falling real rates.

Be that as it may, the question remains whether the Federal Reserve should be "pushing harder to lower interest rates." As I indicated to your Committee, we are endeavoring to pursue a policy that is conducive to noninflationary growth of the economy. But it is important to remember that monetary policy is far from the only determinant of the course of economic developments, and there are limits to what we can do to encourage growth without sowing the seeds of future difficulties. Our economy is suffering from serious imbalances that cannot be overcome through monetary expansion; sound U.S. fiscal policy and adequate growth of demand abroad clearly are two critical ingredients to rectifying those imbalances.

2
GARN--VOLCKER

Question: In recent years, M1 has been growing much faster than nominal GNP and, as a result, M1 velocity has been falling.

The Federal Reserve has sought to explain these developments in terms of factors, such as the availability of NOW accounts and lower interest rates, that have caused people to want to hold larger money balances relative to their spending.

An alternative explanation is that transactions (such as the purchase and sale of financial instruments) which are not included in GNP have grown faster than GNP. Transactions balances must be held against these non-GNP transactions, and when velocity is measured as the quotient of GNP divided by M1, velocity appears to have fallen.

If this alternative explanation is correct, monetary policy has not been as expansionary as would be suggested by the rapid growth in M1 relative to GNP.

What is your view of this alternative explanation of the decline in M1 velocity and its implications for monetary policy?

Answer: In principle, an increase in financial transactions relative to GNP should add to the public's need for M1 balances relative to GNP, thereby tending to reduce velocity. The evidence suggests that in practice, however, a strong rise in financial transactions probably has played only a minor role in the recent strength of M1. A major reason may be that the vast bulk of these transactions are undertaken by dealers, institutional investors, and other agents that are quite efficient in their use of M1 balances. One type of financial transaction that likely had some impact--in part because it involves the retail market--is mortgage financings. The surge in activity in this market probably boosted M1 growth to some extent this year. However, the decline in M1 velocity appears largely to reflect other factors--especially the decline in interest rates, which has reduced the income sacrificed in holding such highly liquid assets. The Federal Reserve has considered all of these influences on M1 in evaluating its behavior.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM PAUL A. VOLCKER

Question: Do you anticipate interest rate reductions in Germany or Japan?

Answer: Interest rates have declined in Germany and Japan over the past year, although not as much as in the United States. The decline in interest rates in Germany and Japan, and to some extent elsewhere, have occurred in an environment of greater price stability and relatively weak economic growth in these countries, particularly growth arising domestically. While I and others have indicated that it is in these countries' interests, as well as the interest of the global economy, to pursue economic policies that would generate adequate and sustained "home grown" economic growth, it remains the responsibility of the national authorities to decide how to achieve it. Whether or not interest rates will decline further in the near-term in Germany and Japan depends upon developments in these economies more generally as well as upon policy choices open to the authorities.

2
D'AMATO--VOLCKER

Question: If Japan and Germany won't agree to follow the U.S. lead and reduce their interest rates, how will the coordination of economic policies as outlined in the Tokyo Summit communique be achieved?

Answer: The question of coordination of economic policies among industrial countries extends beyond whether other countries follow the lead of the United States. Such policy coordination in the end depends on an ongoing dialogue among officials of the major industrial countries concerning their assessments of economic performance and prospects in their respective countries and a policy environment conducive to achieving sustainable, non-inflationary growth in industrial countries and narrowing imbalances among them. Institutions and fora for such coordination have existed and have been reasonably effective for decades; with the political impetus derived from the Tokyo Summit, efforts are being made to render them more effective.

Given the increasing interdependence of the major industrial countries, the effects of the actions or inactions by one country on others are becoming increasingly important. Authorities of the major industrial countries must take into account the effects on their own economies of economic conditions in their major trading partners and must similarly recognize that their economic performance affects others. Mutual awareness of this increasing interdependence over time could lead to a better coordination of economic policies among the industrial countries.

3
D'AMATO--VOLCKER

Question: If interest rate reductions, combined with the drop in the dollar, don't stimulate growth in the U.S., what policy changes would you recommend?

Answer: This is a very difficult, hypothetical question. It seems to me doubtful that declining interest rates and the lower dollar would not have some stimulative effect, all other things being equal. At the same time, I have repeatedly emphasized the limitations on "easy money" and exchange rate changes as a solvent for our economic difficulties. We already have clearly excessive debt creation in the United States and we remain highly dependent on capital inflows from abroad. Your question does underscore the limitations of domestic demand stimulus in addressing satisfactorily the major problems we face. For example, a healthy solution to the problem of the uneven pattern of economic activity associated with our trade imbalance will require, in my judgment, healthy "home grown" growth in other major industrialized countries. At the same time, it is essential that we move forward with actions to reduce outsized federal deficits that have been intertwined with our foreign imbalances. Clearly, there are other problems of a structural nature, such as the Third World debt difficulties, that require continued efforts on many fronts to assure their satisfactory resolution.

4
D'AMATO--VOLCKER

Question: The U.S., its allies, and the multilateral development banks just agreed to an emergency loan for Mexico. Given the size of this commitment:

A. Do you anticipate similar agreements for other oil-exporting debtor nations?

B. Are there enough funds to assist the other oil-exporters such as Venezuela, Ecuador, Nigeria, Indonesia, et al?

C. Do you see the oil price drop as temporary? Shouldn't these debtor nations be forced to adjust (as the oil-producing states in the U.S. are being forced to do) instead of increasing already heavy debt burdens?

D. Won't increased commitments to these large debtors restrict the flow of funds (particularly concessional funds) to the least-developed debtor nations?

Answer: The bulk of the funds of the financial package for Mexico is to come from international financial institutions (the International Monetary Fund and the World Bank) and commercial banks. The international institutions are currently sufficiently liquid to provide the new lending for Mexico, while at the same time remain able to meet calls on them by other potential borrowers, including other oil-exporting countries. The flow of nonconcessional funds to the least-developed debtor nations is relatively small and will not be restricted because of new lending to Mexico. The concessional lending for these countries is provided by other international institutions and by bilateral donors.

All oil-exporting countries are being adversely affected by the decline in world oil prices. However, the impact on Mexico was particularly acute because of Mexico's heavy reliance on oil revenue and its limited international reserves.

5
D'AMATO--VOLCKER

The objective of the new financial arrangements for Mexico is to support Mexican efforts to adjust to the reality of lower oil prices. In particular, the Mexican Government has agreed to restructure its economy and, thereby, develop its non-oil export sector and become less dependent on oil, and at the same time, to continue to pursue complementary macroeconomic policies, including reducing the budget deficit and curbing the growth of consumption. The increased borrowing on a moderate scale is intended to limit somewhat the size of the immediate adjustment for the Mexican economy without reducing its longer-run magnitude.

The outlook for oil prices is, of course, highly conjectural.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MATTINGLY FROM PAUL A. VOLCKER

Question: Assuming there is not sufficient time remaining in the current session to pass comprehensive banking legislation, would the Fed prefer a moratorium on the approval of new "nonbank bank" charters as opposed to not addressing the issue in any fashion before adjournment?

Answer: The Board on numerous occasions has urged Congress to adopt comprehensive legislation to deal with the serious and urgent problems facing the depository institutions industry, including the provision of new products and services and the closing of loopholes that undermine the fundamental structure and basic safety and soundness of the banking system. The Board believes that these issues have been the subject of extensive public hearings, testimony, and debate, and that a sufficient record exists for Congressional action this year. However, with the understanding that a short moratorium on new nonbank banks (and with some limitations on the activities of existing nonbank banks) cannot be an effective substitute for more comprehensive action, such a moratorium would be clearly useful as a prelude to the needed larger effort. I would hope, of course, that a more comprehensive bill will be enacted at the earliest possible time.

2
MATTINGLY--VOLCKER

Question: At a time when many financial institutions are in severe financial straits, would the safety and soundness of the country's financial system be threatened or adversely affected by Congressional elimination or restriction of the deduction for loan loss reserves?

Answer: The taxation of loan loss reserves could have a negative effect on the safety and soundness of the country's banking system. Banks might be discouraged from maintaining loan loss reserves as large as they otherwise might have done under current tax law. The elimination or restriction of the deduction of loan loss reserve provisions could increase the costs banks incur in establishing and maintaining such reserves. In particular, the ability of banks to retain and attract capital would be affected adversely by the five-year recapture provision, which would subject 1985 reserve balances to taxation.

I have stated to the Senate Banking Committee that, as a regulator, I am in favor of measures that will encourage banks to build up and maintain adequate loan loss reserves because I believe this will promote their safety and soundness. The increased taxation of loan loss reserves is inconsistent with this objective. As you know, however, the conference report does change existing provisions in this respect.

3
MATTINGLY--VOLCKER

Question: Some financial publications have speculated that the Federal Reserve has tentatively agreed to approve the controversial Citicorp application interpreting the phrase "principally engaged" in the Glass-Steagall Act. Moreover, they allege the Fed will delay a formal decision until Congress adjourns to avoid incurring the wrath of the legislative branch. What is the status of the Citicorp application? Will you provide the Committee with the minutes of any discussions on the issue? How many other bank holding companies have submitted similar applications?

Answer: The Board has discussed Citicorp's current application to underwrite and deal in certain securities on the basis that it would not be "engaged principally" in that activity under Section 20 of the Glass-Steagall Act on three occasions: May 13 and December 4, 1985, and March 28, 1986.

The Board has not, however, reached a decision on the application. While the application has not yet been rescheduled for Board consideration, the Board has also made no decision to delay reaching a determination until after Congress adjourns.

In addition to Citicorp's application, J.P. Morgan & Co., Incorporated, and Bankers Trust New York Corporation have filed applications to underwrite and deal in certain securities on the basis that they would not be "engaged principally" in that activity within the meaning of Section 20 of the Glass-Steagall Act.

With regard to the minutes of those meetings, the Board's practice has been not to release minutes prior to final Board action on an application, because such release could prejudice the Board's decisionmaking process on the application.

4
MATTINGLY--VOLCKER

Question: Last November I introduced legislation, along with Sen. Bill Bradley, to establish U.S. policy on exchange rates and developing country debt. This legislation was also incorporated into the bipartisan Trade Enhancement Act, S. 1860. Sen. Bradley, in the meantime, has criticized the ineffectiveness of the so-called "Baker Plan" on Third World debt and has proposed a plan to cut interest rates as well as forgiveness of a certain percentage of the debt. Mr. Volcker, you have in the past rejected proposals that call for cancellation of Third World debt; would you please, for the record, comment on Sen. Bradley's proposal?

Answer: The "Bradley Plan" entails no new bank lending, although it does provide substantial amounts (some $3 billion per year) in increased multilateral development bank lending. Senator Bradley is opposed to solutions that involve new bank debts. Instead, his plan calls for interest rate relief (3 percentage points for three years) and principal forgiveness (3 percent of outstandings for three years) from both commercial bank and official creditors. These figures, however, are targets to be negotiated each year and are to be conditional on the debtors making certain structural adjustments.

The "Baker Plan" involves a significant amount of new bank lending and in that respect appears to be the opposite of what Senator Bradley wants. However, it should be pointed out that both the Baker Plan and the Bradley Plan have much in common, including the objectives of structural adjustment and growth in the debtor countries and more support from the multilateral development banks.

Taking the recently announced Mexican program as an example of the Baker Plan approach, banks are expected to provide some $6 billion in net new lending to the public sector over a two-year period. In contrast, the interest rate relief granted to Mexico under the Bradley Plan, that is, external interest payments that would not have to be made, would amount only to $2 billion per year, assuming all Mexican public sector and publicly guaranteed bank debts were affected. From the point of view of balance-of-payments financing, the forgiveness of principal involved in the Bradley Plan is irrelevant--other than the extra boost to interest relief that it contributes, which is included in the above figure--since no amortization of bank debts is included in the Mexican program.

Quite aside from the amount of external finance provided by the two approaches, there is the fundamental question of how Senator Bradley's proposal could be implemented. How would consensus be reached at the "summit" among the representatives of the banks, the official creditors, and the World Bank? What mechanism could be used to induce or force the banks to provide the concessions? What would be the implications for the debtors' future access to credit markets? How would the summit effectively discriminate among the deserving and less deserving borrowers?

In my opinion, Senator Bradley's plan does not appear to be a practical or even desirable approach. It provides less immediate help on balance-of-payments financing than does the approach outlined in the Baker Plan. Moreover, the help that the Bradley Plan does provide--assuming that somehow the parties involved could agree on how to implement it for specific countries--would come in a way that affects adversely banks' financial health and probably would hamper the debtor countries' access to commercial bank credits in the future. Restricted access to bank finance--including trade credits and interbank lines--would be a high price for the middle-income developing countries covered by the Baker Plan to pay for the amount of debt relief envisioned by Senator Bradley. Finally, I believe it would be very difficult, in the framework proposed, to in fact discriminate among borrowing countries as to the amount and nature of interest rate relief, raising a question about the efficacy of the approach in achieving its reform objectives.

Question: We are seeing some signals that perhaps the U.S. economic recovery is not as robust or sustainable as we had predicted. What steps is the Fed prepared to take or endorse to encourage, for instance, business growth? How real a threat is inflation if adjustment "policies" are adopted?

Answer: The economic expansion has been somewhat weaker this year than many had hoped or expected. It is against this backdrop, including favorable price performance, that the Federal Reserve has pursued an accommodative monetary policy.

Although we believe that many ingredients of stronger business expansion are in place, there are obvious strains and uncertainties in the economy today, and we shall have to continue monitoring developments closely to judge what further steps, if any, are needed. I believe that your question correctly calls attention to the fact that, while price pressures seem on the whole well-contained at present, we must be careful to avoid reinvigorating inflation down the road through monetary excesses. This underscores the importance of bringing a comprehensive approach to the achievement of our economic goals, including sound U.S. fiscal policy and policies abroad that promote satisfactory growth in the other industrialized economies.

7
MATTINGLY--VOLCKER

Question: Yesterday's agreement between Mexico and the International Monetary Fund is being hailed as the first successful application of the "Baker Initiative". You were, I believe, instrumental in crafting the loan package. There are estimates that Mexico will now need as much as $6 billion in new commercial bank loans over the next two years for the package to succeed. Commercial banking interests have been, and I believe rightly so, reluctant to expand in any way their exposure among the developing debtors. With regard to Mexico specifically, commercial banks are owed over $75 billion. Can the banks reasonably expect to recover the majority of this debt and, if not, what incentive is there for them to follow the lead of the IMF and the Treasury Department and make new loans? Wouldn't it make better sense for commercial banks to resign themselves to writing off a certain portion of this debt? It seems like we are left to make the decision which is the lesser of two evils.

Answer: There are circumstances under which some additional new lending can preserve the value of existing loans. This seems particularly to be the case for the new money that Mexico's commercial bank creditors are expected to lend to Mexico in the next two years as part of the recently announced package. The new loans will be used to support a comprehensive program of policy measures aimed at achieving macroeconomic stability, structural adjustment, and sustainable economic growth in Mexico. Assuming they are successful, these measures will protect the value (and ultimate collectibility) of Mexico's existing bank debts. Thus, it seems to me reasonable that a bank reach the judgment that it is in its own self-interest to support Mexico's economic and financial program by some new lending. The key is, of course, the prospects for the Mexican economy, given the reform measures undertaken.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

PAUL A. VOLCKER

Question: In July of 1984 when you testified before this Committee you said that high interest rates in the United States, which were partly the result of the big federal budget deficit, had raised the value of the U.S. dollar, thereby hurting our exporters and boosting foreign imports to this country. I agree with you.

In the last year the dollar has fallen dramatically against the yen, Deutschmark, franc and pound. Yet the U.S. still has massive budget deficits. Were we wrong in 1984 in attributing the over-valued dollar to our irresponsible budget deficits? Are such budget deficits still a major cause of our still growing trade deficit and if so how?

Answer: I do not think we were wrong to attribute much of the rise in the exchange value of the dollar to our massive federal budget deficits. These deficits contributed significantly to the strong growth of demand in this country and to a level of domestic interest rates higher than they would otherwise have been. Essentially, these interest rates attracted savings from abroad that helped to finance our budget deficits, but in the process the exchange rate for the dollar was bid up. The high value of the dollar and the strong growth of domestic demand resulted in the high trade and current account deficits we have been experiencing.

While our budget deficit persists at a high level, the economic environment has changed. Inflation rates have come down markedly from rates earlier in the 1980s, real economic growth has slowed, and interest rates have declined substantially. The exchange rate for the dollar, too, has declined, by about 30 percent from its peak in early 1985 (as measured on a multilateral-trade weighted basis).

2
PROXMIRE--VOLCKER

The decline in the dollar's value will tend to reduce our trade deficit, but the lags in that process are considerable and somewhat uncertain. The trade deficit will come down faster and further if growth of domestic demand in other major countries were to strengthen. I might note, however, that as long as our budget deficits persist, the inflow of capital from abroad that is the counterpart to our current account deficits is to some extent welcome.

3
PROXMIRE--VOLCKER

Question: On pages 14 and 15 of your prepared statement you discuss the international debt problem. On June 25 our Committee had a hearing on that problem and it became clear that there are major differences of opinion between the more exposed and the less exposed banks about how each should deal with their exposure in various LDC countries. A witness from one large bank noted, for example, that the less exposed banks might well prefer to write the debt off while those with more exposure could not afford to do that. A witness for a smaller bank noted that "many smaller banks might prefer to drastically lower interest rates rather than contribute new funds." Is there such a split between the larger and smaller banks on how to deal with the debt problem?

Answer: I believe there is an underlying community of views on the kinds of responses to international lending problems that are in the long-term interests of lending banks and major international borrowers. The lending institutions as well as borrowing countries have a large stake in returning to an environment in which the creditworthiness of borrowers can be maintained.

Given the large number of banks holding claims on major international borrowers facing debt-servicing problems, however, it is not surprising that there exist specific differences of views among creditors on how to deal with debt problems. These differences of views cut across the size of banks and reflect their exposure to particular debtor countries and also reflect the financial condition and management position of the banks. Despite such differences, however, it is noteworthy that over the past four years the commercial banks as a group have found it in their overall interest to formulate financial arrangements that provide net new money and restructuring of outstanding debt for a wide range of borrowing countries.

Moreover, widespread expressions of support for the Initiative announced by Secretary Baker last fall have come from banks of all sizes and countries. There seems to be general agreement on the need for Secretary Baker's plan for dealing with debt problems through a program for sustained growth involving new loans to borrowing countries over a three-year period from multilateral institutions and commercial banks. The Baker Initiative continues to offer the best approach for improving the ability of debtor countries to meet their international obligations while at the same time satisfying their domestic needs for economic growth.

5
PROXMIRE--VOLCKER

Question: Has the Fed discarded M-1?

Your statement and report indicate that M-1 will be given less attention than the other monetary aggregates. Indeed, some observers have concluded the Fed has decided to virtually ignore M-1 as a relevant monetary target.

For example, in the first week of July, M-1 increased by a whopping $7.4 billion or more than 1 percent. This would produce an annual growth rate of over 50 percent if continued.

Would it be correct to conclude that the Fed is no longer paying any attention to M-1 as a monetary target?

Answer: The Federal Reserve is placing less emphasis on M1 as a guide for monetary policy, but the growth of this aggregate continues to be evaluated in the conduct of policy. The episodes of surprisingly rapid growth of M1 relative to nominal GNP--that is unusual declines in velocity--that have occurred in the 1980s have raised the degree of uncertainty surrounding the interpretation of this monetary aggregate's behavior. As a result, the behavior of M1 is being judged in light of movements in the other monetary aggregates, and against the background of developments in the economy and financial markets more generally.

Concerning the M1 increase in the week of July 7, the Federal Reserve statistical release in which such data are published has indicated for some time that "special caution should be taken in interpreting week-to-week changes in money supply data, which are highly volatile and subject to revision." In the subsequent week, for example, M1 fell nearly $1 billion, highlighting the range of week-to-week changes and the pitfalls of extrapolating weekly M1 growth.

6
PROXMIRE--VOLCKER

Question: There are times when I think the concept of velocity is a magic wand that covers up a multitude of sins by the Federal Reserve. You refer to changes in velocity as reflecting changes in the public's demand for money balances. But it also reflects changes in the willingness of the Federal Reserve to supply more money balances. Indeed, a supply-side focus on velocity leads to the conclusion that the Federal Reserve is pursuing a dangerous and highly inflationary policy.

After all, the change in velocity is nothing more than the difference between the growth rate of the money supply and nominal GNP. If the Fed decides to supply a lot of new dollars in excess of nominal GNP growth, we will see a sharp decline in velocity as happened over the last 12 months.

How can we be sure the decline in velocity really stems from the public's demand for more dollar balances and not to the Fed's excessive supply?

Answer: This is really a rather central question in terms of the conduct of monetary policy. Clearly, the implications for the economy are quite different if we are, in essence, causing the supply of money to expand faster than the demand rather than meeting a rapidly expanding demand for money associated with a falling return on money balances in an environment of moderate growth and diminishing inflation. Obviously, as discussion of the events and our economic forecasts indicate, we believe that what has been going on is more the latter than the former. In arriving at that judgment, we look at many bits of information, including the patterns of money behavior. But prudence dictates that such a judgment must be regarded as only tentative, and we shall remain vigilant as additional evidence accumulates about the effects of our actions.

7
PROXMIRE--VOLCKER

Question: In your statement, you mentioned that the real economic growth rates of West Germany and other major countries have lagged behind U.S. growth rates, contributing to our massive trade deficit. And yet, no amount of persuasion by us seems to have been able to get these countries to pursue more stimulative economic policies.

If that is the case, it raises serious questions about the ability of the major countries to manage exchange rates. As you know, a reasonable amount of economic policy coordination is an essential precondition for reducing exchange rate fluctuations.

What is being done in the Federal Reserve and the Treasury to strengthen the machinery for economic coordination among the major trading nations?

Answer: I believe the machinery for economic coordination among the major trading nations is not lacking. U.S. officials, both from the Treasury and the Federal Reserve, have had for decades ongoing contact with their counterparts in the major industrial countries, both in bilateral meetings and in multilateral fora where ways to achieve disciplined and complementary domestic policies among the leading nations are discussed. While at times the direct results of these discussions are not apparent, over time the awareness of the effect of the economic performance and economic policies of each country on others is taken into account in the formulation of policies.

What seems to be lacking now is a common judgment about what policy actions are necessary abroad or, indeed, whether any policy actions are necessary to yield a satisfactory growth of domestic demand. No policymaker can be expected to pursue policies that he or she does not deem to be in the country's own best interest. The further question, for the United States and others, is whether those judgments properly take into account the indirect influences on the world economic environment, which in turn influence the sustainability of domestic policies. It is in this area that methods for achieving an international consensus are important.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM PAUL A. VOLCKER

Question: It is widely considered that a western economic growth rate of at least 3 percent is necessary to prevent an aggravation of the Third World's debt problems and to head off a further rise in western unemployment.

Economists at the Organization for Economic Cooperation and Development in Paris now doubt whether their bellwether prediction that the world will just reach the magic 3 percent threshold this year can now be realized. Certainly the economic picture in Japan, Germany and the United States is not encouraging at the moment.

* What happens to the Third World's debt problems--and how much is that problem aggravated--if the western economic growth rate does not reach at least 3 percent?

* How much of a rise can we expect in western world unemployment?

Answer: The debtor countries need a global economic environment that will provide them the assurance that they could earn enough export revenue with which to meet import requirements and to service their debt obligations. I do not think 3 percent is a magical figure that must necessarily be met every year to provide such an environment, but it is entirely true that sustained and reasonably vigorous economic expansion in the industrial countries over time is a key ingredient in dealing with the debt problem. The expansion in the major industrial countries in the first half of the year has been disappointing, and has made it more difficult for developing countries to earn foreign exchange. However, most debtor countries, with the notable exception of the large oil exporters, have continued to make progress in dealing with their debt problems. That effort will need to be supported by more adequate growth in the industrialized world.

Because of the relatively slow growth in foreign industrial countries, they have made only limited progress in reducing the high rates of unemployment that have been recorded in recent years, and in some cases unemployment rates have actually increased slightly. Without an acceleration of growth in these countries, the prospects for a significant reduction in unemployment rates is not favorable.

Question: What happens to the United States economy if we do not get the faster growth in key foreign economies that you say is desirable?

Answer: Sooner or later the U.S. external position will have to improve. Heavily indebted developing countries also need to avoid large external deficits. The other side of the coin is that very large surpluses of some countries cannot reasonably continue to grow and thus provide support to their economic expansion. Consequently, adjustments in these external positions must be made. It is preferable that these adjustments take place by increasing our exports and those of the developing countries in the context of a healthy and growing world economy. The alternative might well mean that external imbalances will be reduced in an environment of a relatively weak U.S. and world economy, a self-defeating process.

Question: In your statement you indicate that "there is some concern over the transitional effects of tax reform legislation."

What do you see as some of the short- and long-term effects of the tax reform legislation we are currently considering and how is our economy likely to be affected in the short and longer term by passage of this legislation?

Answer: As comprehensive a tax restructuring as is currently being considered obviously will significantly alter the context in which many economic decisions are made. I don't think anyone can predict with precision all of the ramifications of such action; certainly I don't feel I have the necessary expertise. In the comment about "transitional effects" I had in mind a number of phenomena, including the influence on business decisions of the current uncertainty about the structure and timing of the tax changes, and the possibilities that spending may be shifted forward or delayed as a consequence of the phasing in of the reform measures, among other things.

Question: There has been much concern expressed about the impact of the Senate tax reform bill in existing real estate partnerships, many of which have issued mortgages held by commercial banks and savings and loan associations. Has the Federal Reserve Board conducted any studies or otherwise considered how banks and savings and loan associations could be affected by the retroactive application of the provisions of the Senate tax bill, including the so-called passive rule, particularly as they would apply to those partnerships with staged payments of the equity?

Answer: We are aware of the possibility that many units in the economy will be affected--some positively, some negatively--by changes in the tax laws that they did not anticipate when they made investment and financing decisions. It is unlikely that any set of transition rules is going to be able to prevent all such effects. We do not have any specific "studies" of the partnership rules to which you refer.

4
RIEGLE--VOLCKER

Question: A great deal of importance for your projections regarding future inflation and consumer spending seem to be based on low energy prices.

Haven't we seen a bottoning out of energy prices and aren't they far more likely to go up than down--and if they do go up, what are the likely implications for the economy?

Answer: I can't tell you what will be happening to the price of oil in the months ahead, although I would agree that the low prices reached a few weeks ago are not likely to be sustainable over a long period of time, given the implications for both consumption and exploration. If the price of crude were to move back up moderately--as it has in recent weeks--retail gasoline and fuel oil prices would presumably come under upward pressure but the prices of natural gas and electricity--competing energy sources--do not yet fully reflect the drop in oil prices.

Obviously, if there were to be a major retracing of the oil price decline, it would--as you suggest--sharply alter the inflation outlook in an unfavorable direction. The effects on spending and output are a more complex matter, as the experience of the first half of 1986 amply demonstrated, and much would depend in the short run on the degree of certainty people had about the stability of any energy price level.

5
RIEGLE--VOLCKER

Question: How concerned are you that "the personal saving rate has remained at an historically low level" and what will be the likely effects of such low savings rates during the next recession, or downturn in the business cycle?

Answer: I am concerned about the low personal saving rate from a number of standpoints, including particularly the implications for spending should income grow more slowly or even decline. The low saving rate has been mirrored in an enormous expansion of household indebtedness, which I believe is a point of potential vulnerability for the economy generally. One can question whether, in such circumstances, consumer spending would show the kind of buoyancy that it has in past recessionary episodes.

Question: Do you expect activity in the housing market and the strength of consumer spending to continue and possibly accelerate in the second half of 1986?

Answer: I think there are good reasons to expect continued strength in these areas of the economy in the near term. Real income growth has been strong thus far this year, spending attitudes are very favorable, judging by the survey evidence, and interest rates have declined substantially. However, healthy growth in the economy over time will require a firming in business investment and an improvement in our trade position.

6
RIEGLE--VOLCKER

Question: In the past you and other bank regulators have expressed considerable concern about the adverse impact of low energy prices on banks in the Texas, Oklahoma, Louisiana and Southwest region of the country.

* What can you tell us about the overall condition of the banks in this area of the country since you last testified before us on the subject on May 13th?

Answer: Banks in the Southwest are generally continuing to operate under conditions of considerable stress. The problems at these banks stem primarily from the depressed condition of the energy industry. Given the sharp further decline in energy prices that has occurred this year, asset quality problems in energy loan portfolios have intensified. Moreover, in all too many cases, problems have spread increasingly to real estate and other loans as well, reflecting in part the adverse impact of the energy price decline on the entire economic infrastructure of the Southwest.

Such problems have prompted many banks in the region to add heavily to their provision for loan losses. In so doing, they have suffered poor earnings. From the last quarter of 1985 through the second quarter of 1986, most of the largest institutions in the region, and many of the smaller ones, have reported at least one quarterly loss. In the second quarter alone, three of the largest banking organizations in the Southwest posted losses ranging from $29 million to $281 million.

Economic problems in the Southwest are also manifested in the number of bank failures. Through July 25, 1986, twenty-three banks had failed this year in Texas, Oklahoma, and Louisiana. These accounted for some 29 percent of total bank failures and 56 percent of the assets of all failed banks throughout the nation. The recent failure (July 14, 1986) of First National Bank and Trust Co., Oklahoma City, Oklahoma, a $1.6 billion subsidiary of First Oklahoma Bancorp, was the largest failure this year and the second largest in U.S. history.

The road ahead poses serious challenges for banks in the Southwest. The organizations have been facing up to these challenges, by building loan loss reserves and by taking other measures, but adjustment to the sharply changed economic circumstances will continue to be quite difficult. As you know, a strong federal support apparatus is available to cushion and contain these strains, to protect depositors, and to avoid secondary repercussions. At the same time, I hope the Congress acts this year to deal with emergency interstate bank acquisitions to help reinforce the tools available to us.

Question: Venezuela recently approved a law that would convert into government issued bonds about $7 billion owed to foreign creditors by private Venezuelan borrowers. The bonds would bear a fixed annual interest rate of 5 percent, well below the banks' cost of funds.

* Venezuela in the past has been one of the more reliable debtor countries and I am wondering if this is the beginning of a pattern on the part of the debtor countries to pay off less of their debt?

Answer: The recent action by the Venezuelan Congress converting debt into bonds is currently being reexamined in Venezuela. I am very hopeful that Venezuelan authorities will find ways to redesign this legislation to meet the Venezuelan objective of spreading out the debt-servicing obligations of private Venezuelan borrowers while at the same time respecting the rights of Venezuelan creditors in a responsible manner.

8
RIEGLE--VOLCKER

Question: What, if anything, do you believe should be the obligation of the Japanese, in light of their huge trade surplus with the United States, and their limited spending for defense, to increase their capital contributions to the lesser developed indebted countries?

Answer: By definition, a country that runs a current account surplus also runs as a counterpart a capital account deficit. Thus, the huge current account surpluses that Japan has been recording are matched by equally large net capital outflows, to both industrial and developing countries.

Private Japanese investors, like investors everywhere, base their investment decisions primarily on expectations of yields and other financial and safety considerations. The amount of Japanese capital flows to the developing debtor countries on the whole is determined by similar considerations. However, Japanese banks have recognized their responsibility to help support appropriate adjustment efforts in financially strained developing countries, and have participated in the various financial packages that have been arranged for individual debtor countries. Moreover, the Japanese Government, including entities such as Japan's Export-Import Bank, have negotiated special lending programs to particular borrowing countries. Those and further efforts by a country with an enormous current account surplus appear entirely appropriate in reducing the disturbing effects of that surplus on the world economy and helping to deal with particular points of strain.

9
RIEGLE--VOLCKER

Question: In the past monetarists have been quick to point out the relationship between growth of the economy and growth of the money supply, but that relationship no longer seems to be there.

* How do you account for the confused readings we are now getting and what are the implications for future monetary policy of the economy's listless performance on the one hand and the money supply's explosive growth on the other?

In terms of setting monetary policy, it seems to me that spotting and monitoring the money that matters the most has become increasingly difficult.

* How would you define the money that matters the most? Is it M-1? M-2? M-3? Or some new variation?

Answer: A major factor boosting the growth of M1 relative to income has been sizable declines in market interest rates, which make it less costly--in terms of interest foregone--for the public to hold such liquid assets. The sensitivity of M1 to interest rate movements in recent years probably has been heightened by deposit deregulation and the spread of corporate cash management techniques. Consequently, the relationship of M1 to economic activity, prices, and interest rates remains quite uncertain at this time, and a firm conclusion regarding the properties of the behavior of this aggregate in an evolving institutional and economic setting probably will require considerably more experience.

The broader monetary aggregates, which encompass many of the shifts between liquid and less liquid assets, have behaved more in line with their historical patterns, although they are currently also growing somewhat faster than nominal GNP. Both M2 and M3 are within their current target ranges, and maintenance of growth within their ranges for 1986 and 1987 is believed to be consistent with a pickup in the pace of economic activity from that of the first half of this year.

The behavior of all the traditional measures of money, though, at times has been substantially affected by financial innovations and deposit deregulation. And, while research continues on alternative measures of the money stock, even with refinements, they too probably will be subject to many of the same influences. In this environment, the implementation of monetary policy has involved continuing appraisal of the relationships among all the various measures of money and credit, their velocity trends, indicators of economic activity and prices, as well as conditions in domestic credit and foreign exchange markets. So, in a sense, what "matters the most" is not a single measure of money, but rather the monetary aggregates collectively viewed in a broader context.

11
RIEGLE--VOLCKER

Question: Recently one of your fellow Board members (Rice) gave a well-publicized speech entitled "Is Inflation Licked?". He concluded that the answer was "No" and warned that continued attention should be paid to this issue. He noted among other things that apart from energy, actual inflation rates still are in a range that, only a decade and a half ago, were viewed as being so intolerable that they led to a program of extensive wage and price controls.

* What are your views on whether inflation is likely to be a problem within the next 1 to 2 years?

Answer: It clearly is the case that our recent, highly favorable price performance has owed much to the extraordinary drop in oil prices. As those prices level off or rebound, and as we absorb the impact of the lower dollar, some pickup in recorded inflation is highly likely, as is suggested by the forecasts of the Board members and Reserve Bank presidents in our report. Looked at another way, a broad range of important prices, particularly in the service area, have continued to rise persistently, lending an underlying inflationary momentum to the economy.

I do believe that we have made solid progress in the fight to achieve and maintain reasonable price stability, but recent trends provide no grounds for complacency. Certainly the need to build on past progress in keeping the underlying trend of inflation down must remain a prime objective in considering appropriate monetary policy. By its nature, the inflationary process tends to perpetuate itself. The price increases anticipated over the next year or two as we absorb higher import costs and oil prices level off or rebound may be moderate and temporary, but that will be true only if policy remains alert to the danger.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DIXON FROM PAUL A. VOLCKER

Question: Mr. Chairman, the conference on the tax reform bill is now underway. Earlier this year, you expressed your concern over efforts to tax bank loan loss reserves. Do you continue to be opposed to taxing loan loss reserves?

Bank failures are at a record rate. The rate of return for banks is falling, and banks are under increasing pressure to raise more capital. Can you tell the Committee what the impact on the banking system would be if loan loss reserves were taxed?

Answer: As I responded to the question posed by Senator Mattingly, the taxation of loan loss reserves could have a negative effect on the safety and soundness of the country's banking system. Banks might be discouraged from maintaining loan loss reserves as large as they otherwise might have done under current tax law. The elimination or restriction of the deduction of loan loss reserve provisions could increase the costs banks incur in establishing and maintaining such reserves. In particular, the ability of banks to retain and attract capital would be affected adversely by the five-year recapture provision, which would subject 1985 reserve balances to taxation.

I have stated to the Senate Banking Committee that, as a regulator, I am in favor of measures that will encourage banks to build up and maintain adequate loan loss reserves because I believe this will promote their safety and soundness. The increased taxation of loan loss reserves is inconsistent with this objective. As you know, however, the conference report does change existing provisions in this respect.

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